FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

1150-7

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OF THE

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CONTENTS

Panel discussions: **Page**

Focus of tax policy: Short-run stabilization and long-run growth 4

Summaries of statements in compendium:

Keezer, Dexter M., McGraw-Hill Publishing Co., Inc 4

Hansen, Alvin H., Harvard University 6

Colm, Gerhard, National Planning Association 8

Woodward, Donald B., Vick Chemical Co 9

George, Edwin B., Dun & Bradstreet 11

Hagen, Everett E., Massachusetts Institute of Technology .. 14

Impact of Federal taxation on the distribution of real income and levels of consumption 47

Summaries of statements in compendium:

Bach, G. L., Carnegie Institute of Technology 47

Musgrave, Richard A., University of Michigan 49

Andersen, Theodore A., Dartmouth College 50

Impact of Federal taxation on the amount and character of private investment 95

Summaries of statements in compendium:

Burgess, Ralph E., American Cyanamid Co 95

McCracken, Paul W., University of Michigan 97

Impact of Federal taxation on management, entrepreneurial efforts and on type of remuneration, effects on labor supply and professional skills 132

Summaries of statements in compendium:

Long, Clarence D., Johns Hopkins University 132

Schulman, Robert A., Wenchel, Schulman & Manning, Washington, D. C 134

Driscoll, Joseph P., attorney, Washington, D. C 135

Greenewalt, Crawford H., E. J. du Pont de Nemours & Co .. 137

Relative emphasis in tax policy on encouragement of consumption or investment 165

Summaries of statements in compendium:

Davidson, John C., National Association of Manufacturers .. 165

Fellner, William, Yale University 171

Ruttenberg, Stanley H., AFL–CIO 174

Samuelson, Paul, Massachusetts Institute of Technology ... 177

Schmidt, Emerson P., Chamber of Commerce of the United States 179

Stein, Herbert, Committee for Economic Development 182

Economic impact of expansion and contraction of the tax base 231

Summaries of statements in compendium:

Paul, Randolph E., Paul, Weiss, Rifkind, Wharton & Garrison, Washington, D. C 231

Blum, Walter, University of Chicago 234

Cary, William L., Columbia University 235

Atkeson, Thomas C., College of William and Mary in Virginia 241

Groves, Harold M., University of Wisconsin 243

Relationship of exemptions and deductions in the individual income tax to economic stability and growth 277

Summaries of statements in compendium:

Holland, Daniel M., National Bureau of Economic Research . 278

Kahn, C. Harry, National Bureau of Economic Research ... 281

Strayer, Paul J., Princeton University 283

White, Melvin I., Brooklyn College 285

Panel discussions—Continued | Page
Economics of capital gains taxation ... 307
Summaries of statements in compendium:
Brown, Jonathan, New York Stock Exchange ... 307
Heller, Walter W., University of Minnesota ... 309
Shoup, Carl S., Columbia University ... 311
Surrey, Stanley S., Harvard University ... 312
Butters, J. Keith, Harvard University ... 314
Impact of Federal taxation on natural resource development ... 350
Summaries of statements in compendium:
Fernald, Henry B., of Loomis, Suffern & Fernald, New York City ... 350
Gray, Horace M., University of Illinois ... 351
Harberger, Arnold C., University of Chicago ... 355
Lambert, Scott C., Standard Oil Co. of California ... 357
Nelson, James R., Amherst College ... 358
Stanley, Lowell, Monterey Oil Co ... 360
Smith, Arthur A., First National Bank in Dallas, Dallas, Tex ... 362
Effectiveness of tax depreciation policy in counteracting economic fluctuations and promoting economic growth ... 413
Summaries of statements in compendium:
Brown, E. Cary, Massachusetts Institute of Technology ... 413
Dean, Joel, Joel Dean Associates, Yonkers, N. Y ... 415
Eisner, Robert, Northwestern University ... 416
Paton, William A., University of Michigan ... 417
Terborgh, George, Machinery and Allied Products Institute ... 420
Commodity taxation in tax policy for steady growth ... 456
Summaries of statements in compendium:
Due, John F., University of Illinois ... 457
Lutz, Harley L., Princeton University ... 458
Stephenson, E. C., J. L. Hudson Co., Detroit, Mich ... 460
Zelomek, A. W., International Statistical Bureau, Inc., New York City ... 462
Corporate income taxation ... 497
Summaries of statements in compendium:
Silverstein, Leonard L., Washington, D. C ... 497
Rudick, Harry J., of Lord, Day & Lord, New York City ... 499
Taylor, W. Bayard, Claremont (Calif.) Men's College ... 500, 541
Keith, E. Gordon, University of Pennsylvania ... 502
Tarleau, Thomas N., of Willkie Owen for Gallagher & Walton, New York City ... 513
Leggett, Herbert A., Valley National Bank, Phoenix, Ariz ... 534
Taxation of small business ... 543
Summaries of statements in compendium:
Adelman, M. A., Massachusetts Institute of Technology ... 543
Cohen, Edwin S., Hatch, Root, Barrett, Cohen & Knapp, New York City ... 544
Hall, James K., University of Washington ... 545
Lintner, John, Harvard University ... 547, 567
Relationship of taxation of income derived abroad to foreign economic policy ... 597
Summaries of statements in compendium:
Blough, Roy, Columbia University ... 597
Wender, Ira T., Lord, Day & Lord, New York City ... 599
Collado, Emilio G., Standard Oil Co. (N. J.) ... 601
Costelloe, John F., Radio Corporation of America ... 602
Economic significance of deferred compensation and pension plans ... 635
Summaries of statements in compendium:
Biegel, Herman C., Lee, Toomey & Kent, Washington, D. C ... 636
Daniel, Eleanor S., Mutual Life Insurance Co. of New York ... 638
Hall, C. A., Jr., Yale University ... 641
Lesser, Leonard, United Auto Workers, AFL–CIO ... 643
Federal, State, and local government fiscal relations and their significance for economic stability and growth ... 669
Summaries of statements in compendium:
Shaw, Eugene G., commissioner of revenue of the State of North Carolina ... 669
Maxwell, James A., Clark University ... 671

Panel discussions—Continued Page
Impact of Federal estate and gift taxation 689
Summaries of statements in compendium:
Eisenstein, Louis, of Paul, Weiss, Rifkind, Wharton & Garrison, Washington, D. C 690
Harriss, C. Lowell, Columbia University 692
Additional information:
Charts:
Rate jumps by income bracket 170
Top rates of corporate income tax 171
Cost of vesting provisions 650
Data on the relative volume of corporate stock financing 538
Effect of retirement and profit-sharing plans on cyclical stability 653
Letters:
Collado, Emilio G., Standard Oil Co. (N. J.), to chairman, Dec. 23, 1955 634
May, George O., New York, N. Y., to chairman, Dec. 7, 1955 275
Walet, Eugene H., Jr., president, Jefferson Lake Sulphur Co., New Orleans, La., to chairman, December 9, 1955 390
Williams, Langbourne M., president, Freeport Sulphur Co., to chairman, December 7, 1953 389
Tables:
Breakdown of spending unit income brackets for $0 to $1,000 and $1,000 to $2,000 58
Comparison of the effective rate of tax paid by taxpayers with adjusted gross income of $100,000 or more on basis of (*a*) adjusted gross income as reported, and (*b*) adjusted gross income plus excluded long-term capital gains 254
Corporate security offerings for cash, excluding issues of investment trusts, trading, and holding companies 541
Distribution of taxable individual income tax returns with itemized deductions by adjusted gross income classes and by surtax net income brackets, 1951 122
Effective rates of tax paid by taxpayers with adjusted gross income of $100,000 or more 253
Estimated effective rates of tax for 1948 and 1954 (tax as percent of spending unit income brackets) 56
Estimated nonreporting of various types of income, 1952 281
Extent of vesting in conventional plans 649
Married persons filing joint returns 123
New corporate security issues for new capital, 1920–29 and 1946–53 539
New domestic corporate security issues, 1920–54 539
Projected plant and equipment requirements 180

FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

MONDAY, DECEMBER 5, 1955

CONGRESS OF THE UNITED STATES
SUBCOMMITTEE ON TAX POLICY OF THE
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The subcommittee met at 10 a. m., Hon. Wilbur D. Mills, chairman of the subcommittee, presiding.

Present: Senators Paul H. Douglas (chairman of the full committee) and Barry Goldwater, and Representative Thomas B. Curtis.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The subcommittee will come to order, please.

Pursuant to the directive of the Joint Committee on the Economic Report, as set forth in its report to Congress last March, the Subcommittee on Tax Policy has been conducting a study of the use of tax policy for the attainment of the objectives of the Employment Act of 1946. We are placing particular emphasis on tax policy needed to maintain a steady and sustainable rate of economic progress. The subcommittee is looking at the broad economic aspects of the tax problem. We recognize there are other important considerations which must be weighed by other committees of the Congress in determining final tax policy.

Those following the study will recall that after preliminary work, the subcommittee met last May 24 with a number of invited economists, accountants, lawyers, and other tax experts. At this meeting, the year's program was formulated. Subjects for intensive research on various aspects of the inquiry were assigned some 81 panel participants. During the course of the summer and fall these experts prepared papers summarizing their findings. These papers were printed in a compendium and transmitted in mid-November to subcommittee members, panelists, and the general public.

On behalf of the subcommittee I wish to take this opportunity to congratulate and thank all the participants for their conscientious work in preparing papers. Everyone who has gone through the compendium knows that a significant contribution has been made to our understanding of tax problems. We welcome the varying views reflected in this volume because we respect the individuals we chose to prepare statements on the various subjects. The compendium is entitled "Federal Tax Policy for Economic Growth and Stability," and is available from the Superintendent of Documents for $2.50.

The 930-page volume promises to be a best seller. Although it has been available only 3 weeks, the Superintendent of Documents

has sold some thousand copies. Distribution of an additional 2,000 copies has been made to Members and staffs of Congress, executive agencies of the Federal Government, depository libraries, and others.

The hearings which commence today are intended to give the subcommittee an opportunity to discuss with the panelists the important issues posed by the presentations.

We will proceed through the volume of papers and hear the panelists in the order in which their papers appear. Because of the variety of subjects to be covered, and the number of panelists to be heard, it will be necessary to conduct these hearings strictly as outlined in earlier releases and communications. At the start of each session, if there is no objection each panelist will be given 5 minutes to summarize his paper.

Is there objection to that procedure?

The Chair hears none.

If there is no objection, we will hear from all panelists without interruption.

Is there objection to that procedure?

The Chair hears none.

In view of this subcommittee action, I want to emphasize that the 5-minute rule will be adhered to, and I have asked the staff to raise a card when the speaker has spoken 5 minutes. Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session. I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee members' questions.

The subcommittee is seeking economic facts. It is my belief that these facts will enable the subcommittee to prepare a unanimous report setting forth broad economic principles which should serve as a guide to the legislative committees and the Congress in making modifications and in improving our tax system during the coming years.

So far in this study I have not read or heard one word indicating that this inquiry has been motivated or conducted on a partisan basis. After working with the members of the subcommittee for over 7 months in a nonpartisan and objective atmosphere, I am very proud of the manner in which the inquiry has been received by Members of Congress, by professional, research, and economic interests groups, by the general public, and by the press.

I am sure that all members of the subcommittee join with me in seeking the truth in these hearings. To me, truth is bipartisan and nonpolitical.

I am glad that the other members of the subcommittee are present this morning.

Do any of the members of the subcommittee wish at this time to make a brief statement before we get under way?

Mr. CURTIS. I would.

Mr. MILLS. Mr. Curtis of Missouri.

Mr. CURTIS. Mr. Chairman, I thank you for the opportunity to make a brief statement inasmuch as at our previous session when we had the panelists present I was unable to be there to make 1 or 2 very general observations.

I am happy to join in the chairman's observations about the value and need of our subcommittee's studies into the economic effects of

our Federal tax structure. In the full committee panel hearings on the President's economic report last January, I several times raised the question on particular economic situations and trends of just what, if any, effect our Federal tax structure had on these matters.

Personally, I have felt strongly for years that our Federal tax structure has had a considerable effect upon our economic structure and that this area needed to be explored. I think the papers that the panelists have prepared for this subcommittee all point up the truth of this surmise.

I want to take this opportunity to express my deep gratification for the scholarly manner in which most of these papers were prepared. By any standard, these thousand pages of studies and observations on the economic aspects of our tax structure are excellent.

These collective studies should prove of great value to the Congress, executive departments, and, indeed, to private enterprise. I trust that this joint committee will continue these studies. After all, the Ways and Means Committee of the House and the Finance Committee of the Senate, in their considerations of tax measures, must perforce be dealing with the details of each specific tax itself and therefore cannot, as well, wander off into the realms of overall political philosophies where the concern is long-time economic and social trends.

Yet, these basic philosophic studies, if objectively made, should be of inestimable value to our tax committees.

I would like to conclude with a personal observation. Looking at these papers collectively, I am impressed with the fact that "taxation for revenue only" seems to have pretty well disappeared from modern-day thinking whether it be of the conservatives or the liberals. Using the taxing powers to produce specific economic results and to operate as the enforcing power behind Government regulations seems implanted in modern political thinking.

I wonder if it would not be well to reexamine this political philosophy? To my conservative friends—I regard myself as a conservative in economic and political philosophy—I suggest that this philosophy did not get its start in the past 20 years of New Deal philosophy. It got its real start in the late 19th century when tariffs were used to produce economic effects instead of revenues. This procedure was simply applied to other aspects of our economy.

To use the taxing power to produce economic effects, the Government must start with a high tax rate, or, as in tariffs, that which it does not want it places beyond the point of diminishing returns. (The concept that the rate of any tax may be so high as to produce diminishing returns is another concept which seems to have disappeared from tax discussions.) I have observed in many instances those whose political philosophies seem to be for a stronger central government arguing along the lines of a broader tax base and those who seem to be for a less powerful central government arguing along opposite lines.

Yet, the governmental power for regulation contained in taxation depends for its strength on the height of the tax rate and the height of the rate to a large degree depends upon the narrowness of the tax base. Of course, the requirements of a high tax take set the basic foundations for this situation.

Thank you, Mr. Chairman.

Mr. MILLS. This morning, we have a panel discussion on the focus of tax policy: Short-run stabilization and long-run growth. We will proceed with the 5-minute opening statements.

Our first speaker will be Mr. Dexter M. Keezer, vice president and director of the economics department, McGraw-Hill Publishing Co.

Mr. Keezer, we are pleased to have you and the other members of the panel with us this morning. You are recognized for 5 minutes.

Mr. KEEZER. Mr. Chairman, I feel privileged to lead off for the guests in what I anticipate will be a monumental discussion of economic growth, stability, and taxes. For a combination of both growth and stability, the American economy has made a record since the end of World War II which will be hard to beat. In physical terms, its growth, as measured by the gross national product, has averaged about 3.6 percent a year. This is a rate of growth about one-fifth higher than the long-term rate of growth since 1910.

At the same time the growth of our economy has been remarkably sustained. In only 1 year (1949) has the gross national product, in physical terms, departed more than 4 percent from a straight line of growth.

In this great record of both growth and stability there has been one grave flaw. It has been attended by a price inflation which since 1945 has robbed the dollar of about one-third of its purchasing power. It can be hoped, however, that by knowing enough and being wise enough we can sustain and even improve on this record of growth and stability while avoiding severe price inflation. I welcome the opportunity afforded by these hearings to try to contribute to this end.

However, I approach the task very humbly.

We have a long way to go before we fully understand the mainsprings of economic growth. The same thing is true of the forces which produce ups and downs in economic activity. When we are trying to comprehend and devise policies to promote both growth and economic stability the complexity of the operation is greatly increased.

I have expanded on this theme in my extended statement and, in so doing, have summarized some of the elements making for growth and making for stability.

In this statement I have also emphasized what seem to me the serious limitations of the gross national product as a measure of economic growth, and stressed the enormous complexity of the problem confronted by the Federal Government in trying to reconcile all the interests involved in any tax program, and in addition, promote both economic growth and stability.

I submit, however, that at this juncture, one of the surest ways to foster both economic growth and stability is to make arrangements, including those crucial arrangements provided by Federal tax policy, which do the best that can be done to assure the maintenance of a high level of capital investment by business.

I am not suggesting that this should be done at the sacrifice of a high level of consumption which, over any considerable length of time, is essential to a high level of investment in our kind of economy. What I am suggesting is that in maintaining a balance between consumption and capital investment, special care be taken to handle the specially exacting problem of maintaining a high level of business investment.

It is generally agreed that the key to economic growth is investment in new and better producing facilities to produce more new and better things. Hence, if we sustain a high level of investment, as we have in this postwar period, we shall have the most crucial ingredient of a high rate of economic growth. We shall also, of course, have stability in a segment of the economy which provides employment for about one-fourth of our industrial workers.

However, a standard fear, shared by many economists, and I believe some of my fellow panelists, is that if we maintain a high level of investment it will result in the creation of excess producing capacity, glutted markets, and other preludes to depression.

Nourishment for this fear can be found in our economic history. I believe, however, that it has become obsolete and that new institutional arrangements and new economic necessities make it both feasible and desirable to sustain a high level of capital investment by business. In support of this view I cite the following considerations which are amplified and supplemented in my detailed statement:

Over the next 20 years our population is expected to increase by about one-third while the hours worked are not expected to increase more than 15 percent. Hence, we must have a relatively large increase in capital equipment if our standard of living is not to suffer.

This is particularly true since about one-half of the total of the business investment at present goes simply to replace wornout equipment and not to expand capacity as was true of the larger part of business investment in the early stages of our industrial development, and as I assume is true of Russia today.

Thanks largely to the impact of organized research for which as a nation we are now spending about $4 billion a year, a large share of capital investment is going to provide new products and new and better processes rather than to expand existing capacity.

In the process of increasing the diversity of our industries through research and subsequent capital investment, we tend to increase general stability, since different industries tend to have somewhat offsetting ups and downs.

The great growth of long-range planning of business investment since the end of World War II has reduced what historically have been the disturbing effects of temporary excesses of producing capacity.

Happily—here I introduce a news note rather than material derived from my extended statement—we have the prospect of a high level of business investment again in 1956. A recent preliminary checkup made by my department at McGraw-Hill indicates that American business as a whole plans to spend about 13 percent more for new producing facilities in 1956 than was spent this year, a record year, and that manufacturing industry plans to spend 30 percent more.

This prospect does not suggest that under present conditions the weight of Federal taxation is stifling business investment. However, there is some reason to believe that it is retarding the growth of smaller companies which I know is a matter of great concern to you gentlemen.

And there is occasion to be closely on the lookout lest a Federal tax which takes more than one-half of corporate incomes above $25,000 adversely affect the level of business investment in the longer run, when, it is to be hoped, the special stimulus to capital investment provided by war and threats of war has fully worn off.

Thank you, Mr. Chairman.

Mr. MILLS. The next panelist is Dr. Alvin H. Hansen, Littauer professor of political economy, Harvard University.

Dr. Hansen, you are recognized for 5 minutes.

Mr. HANSEN. Mr. Chairman, investment is the key to both short-run stability and long-term growth. Unfortunately boom levels of investment have historically turned out not to be maintable for the reason that those levels tended to exceed the long-term growth requirements.

The capital stock—plant, machinery, and equipment, fixed capital goods of all kinds—this capital stock has over many decades grown in something like the same ratio as output. Recently that ratio has been declining some.

Observing this historical ratio of capital to output, it is easy to fall into the error that we can achieve almost any desired rate of increase in real income simply by a deliberate program of accelerating the rate of capital accumulation, or in other words raising the ratio of investment to GNP to a much higher level.

If the historical rate of capital accumulation has made possible an increase in aggregate output of say 3½ percent per annum, why then, it is asked should we not double the ratio of investment to GNP and thereby increase the rate of growth of output by say 7 percent a year. If output is a function of the annual rate of capital accumulation there would seem to be virtually no limit to the rate of long-term growth.

I fear that this line of reasoning fails to come to grips with the real basis of progress. Capital accumulation is indeed a means of implementing progress, but it is not the source of progress. The real source of economic progress is scientific research, inventions, innovations, technology— new ways of doing things, new products, new techniques. Without the advance of technology, capital accumulation would quickly come to an end.

There is, however, the additional factor of population growth. I was here thinking of it in per capita terms.

Thus the amount of net investment which can usefully be added to our capital stock is a function of the progress of technology. If invention and technology can be made to grow at a more rapid rate than in the past, deeper and broader outlets for investment will emerge.

Given the rate of technological advance, there is a danger for stability and steady long-term growth in pushing investment too far, or, in other words, beyond the maintainable rate. This has occurred again and again. Indeed it is just this that has sounded the death knell of every boom in the past.

An artificially inflated rate of capital formation can lead to instability and thereby diminish the long-term rate of growth. We should aim, not at the maximum but at the optimum rate of capital accumulation, and this, I suggest, is primarily determined by the rate of scientific research and technological progress.

Scientific research and inventions in the usual case opens up new investment outlets. But they may at times increase productivity yet lessen the need for capital accumulation. Inventions may be capital saving.

Moreover, expenditures on human resources—education, health, and so forth, may not only contribute directly to living standards, but

may also, no less than capital accumulation, increase the productive capacity of society.

There is far too great a tendency nowadays to plead for policies that encourage investment in material capital goods—plant and equipment; and to forget that outlays to improve our human resources may be ever more productive.

We place too much stress on brick and mortar when we plan for long-term growth in our productive capacity. But we make matters still worse by measuring the growth in income primarily in terms of mere material goods. Material goods must necessarily be the chief cause of concern in a relatively poor country. But have we not by now reached in the United States a degree of plenty with respect to the physical necessities which would permit greater attention to health, education, and more broadly the rich, varied range of cultural activities in general?

It is indeed true that a considerable proportion of our population still lacks adequate housing and even an adequate diet. Nevertheless, we have gone a long way toward meeting our purely material needs, and are spending, I fear, far too much on mere material gadgets.

Twenty years from now, a higher proportion of our active population should consist of professionally trained people. Educational, intellectual, and cultural activities especially for adults can be extended almost indefinitely the more we achieve well-nigh robot perfection, in this era of increasing automation, in the production of material goods. The old argument that we can't afford the professional skills and activities that make for high-grade living is disproven by the events of the last 15 years. We can achieve a $750 billion GNP by 1975.

But mere quantity is not enough. Quality and social priorities at long last must concern us or we perish in the midst of material plenty. Just now we are starving our schools while we race up and down 6 and 8 lane highways in ever newer and longer cars.

And now a word about stability versus growth. There are those who are prepared to sacrifice a not inconsiderable amount of unemployment for stability.

Happily, experience during the last 15 years indicates that it is not impossible to have both full employment and stability, reasonable stability, not in all those 15 years but in a considerable portion of those 15 years.

If we sacrifice full employment we shall not reach our full growth potential. Operating under pressure, the American economy has performed a miracle of production. But we should never have learned what the economy is capable of had we not been operating under the pressure of full employment.

We have in this country two important safeguards against inflation: (1) Our prodigious capacity to increase output when under pressure, and (2) our capacity, both corporate and individual, to save at high-income levels.

If we permit, or even foster, a considerable amount of unemployment; if we pursue what is coming to be known as low-pressure economics, we shall fail to achieve the growth of which we are capable.

Minor recessions from time to time we may not be able to avoid, but we should not welcome them.

Formerly, it was argued that even serious depressions were useful—they cleaned out the debris, it was said, in the economic system. This argument is no longer heard, but we still hear it said that minor recessions may be needed.

The pursuit of continuous long-term growth at a rate equal to our potentialities will require at times very large-scale financial operations by the Federal Government.

This follows from the inherent instability of investment. These operations can and should when needed take the form both of large changes in Government expenditures and large changes in tax rates.

Moreover the long-run trend of nonmilitary expenditures will and should be upward. If we pay due attention to social priorities, to the things that are needed for a truly great way of life, the trend of nonmilitary Federal expenditures should rise considerably more rapidly than the GNP.

This, however, does not necessarily mean any increase in tax rates. This is true, partly because an increase in income under a progressive tax system will produce an increase in tax revenues greater percentagewise, than the increase in income, and partly because a growing national income should be matched more or less by a growth both in the money supply and in liquid assets, primarily United States Government securities.

Responsible fiscal management means one which fosters, not a balanced budget, but a balanced and growing economy. It calls for a careful scrutiny of efficiency in the use of public funds. And it means an optimum allocation of resources as between public and private expenditures based on a far more careful concern for social priorities than is currently in evidence.

Mr. MILLS. The next panelist is Dr. Gerhard Colm, chief economist, National Planning Association.

Dr. Colm, you are recognized for 5 minutes.

Mr. COLM. Mr. Chairman, in my testimony I have attempted to present some material bearing on the question: Will a budget policy designed to promote economic growth permit tax reduction in the immediate future or during the next few years?

An answer first requires an appraisal of the likely development of national security expenditures. I assume in my testimony an increase in national security expenditures for fiscal year 1957 of about $1 billion above this year's estimates. Over the longer run, however, various alternatives were considered in that testimony.

I assume that by 1960 defense expenditures would be either the same as the estimated 1957 levels or $10 billion above or below that level.

Second, the need for nondefense programs, such as for education, health, natural resources, and road construction, had to be reappraised. During the period of the war, postwar inflation, and post-Korean rearmament, programs in these fields were restrained.

They must now be developed lest the deficiencies which have arisen become a serious handicap to balanced economic growth and general welfare. Because of the timelag involved in getting additional programs under way I assume that there would be only a $1 billion increase in nondefense programs in the fiscal year 1957, but possibly a $5 billion increase by 1960.

If present favorable economic conditions continue—and I derive much encouragement from the figures presented by Mr. Keezer—pres-

ent tax rates should give us an approximately balanced administrative budget and a substantial excess of receipts over payments in the consolidated cash budget in the fiscal year 1957. Even though a balanced budget is in sight, however, I would recommend immediate tax reduction only if I were convinced that economic activities are faltering and that an immediate support of purchasing power by tax reduction is needed.

At the present moment I can see no such need. It is of course, quite possible that the rapid economic expansion might lead to a discrepancy between the rise in economic potentials and the increase in active demand. At such a time, tax reduction could give purchasing power the needed support. By premature action we would dissipate the contribution tax policy can make to economic stabilization and growth.

Assuming that over the next few years national security expenditures need not be raised substantially, tax reduction should become possible and will probably be necessary in order to assure a rise in purchasing power commensurate with the rise in the capacity to produce.

Looking over a period of 4 to 5 years I would guess—and there are some details in my testimony—that a tax reduction of a magnitude of $5 to $6 billion may be possible and advisable for supporting sustained economic growth.

Because of the difficulties in appraising far in advance the trend in Government expenditures and in general economic conditions, it is most important to improve our legislative and executive machinery for adapting tax policy to changing conditions. I have proposed a number of such improvements in line with a previous joint policy statement by the National Planning Association. Among these is the recommendation for including in the budget message and in the Economic Report of the President respectively a budget outlook and an economic outlook covering several years.

It is also suggested that the Joint Committee on the Economic Report be reconstituted as a Joint Committee on Economic and Fiscal Policy and should report to the Congress both on economic and fiscal policies.

I further recommend that the Congress should prepare now a program of tax reduction which could be put into effect by prompt legislative action whenever economic conditions require it. I regard the effort of this committee as a step in this direction and for this reason I am particularly grateful for the opportunity to offer my small contribution to this endeavor.

Thank you very much.

Mr. Mills. The next panelist is Mr. Donald B. Woodward, chairman of the finance committee, Vick Chemical Co., New York.

Mr. Woodward, you are recognized for 5 minutes.

Mr. Woodward. Mr. Chairman, I too want to add my congratulations to the committee and to this subcommittee for undertaking this extremely important study and I express appreciation for the invitation to appear.

Economic growth I take to mean broadly the achievement in most years of a higher standard of living for the preponderant part of the population than in any preceding year.

The achievement of economic growth requires more and more tools and skill for workers so that they can produce more, and become better markets for the production of others. If there are to be more tools and skill, there must be saving to provide them.

In this urbanized and specialized economy, a large proportion of savings are made in money. For them to be used most appropriately, properly functioning instruments for the direction of the savings to such uses must exist.

Budget policy and consequent operation have a tremendously large influence upon these factors involved in economic growth, because they largely determine whether Government is preempting some of the savings so important to economic growth, or whether Government operations are generating saving and making them available for the economic-growth processes.

That controversy exists about appropriate budget policy is not surprising in view of its importance. There are three main alternatives which have vocal advocates.

One recommended course is a budget policy that provides that Government have the use of a large part of the savings of the country in all circumstances.

At the opposite extreme is the advocacy that Government should have an exactly balanced budget under all circumstances, and so use none of the country's savings—though an exception is usually made in wartime.

The final of the three alternatives is for the Government and the private sector of the economy to operate in a collaborative manner to assure that income and savings are maximized and that the best use of savings is made under all conditions.

This third alternative seems to me the wisest and most desirable; the two extreme views are unpromising.

We then have the question of how the public and private sectors may be meshed.

One way much discussed over the past 2 decades is for the Government budget policy to decide when and in what amount budgetary operation should utilize or add to the country's savings through incurring surpluses or deficits.

But though plausible, this concept has proved, I submit, unworkable. Its operation required action that neither the Congress nor the Executive is on the record, willing or able to take. Evidently something more reliable than the compensating budget concept is needed.

The other way for budget policy to provide that the public and private sectors complement each other is to leave the decision to the private economy aided by the Federal Reserve System. Under this plan a low—rather than a high-expenditure policy should be adopted and the budget always would be prepared on the assumption that high prosperity will prevail during the time period which the budget is to cover. Tax rates would provide a small surplus from personal and corporate incomes at high levels of prosperity.

But if prosperity does not in fact prevail as the budget would contemplate, then receipts would fall and outlays would rise as a result of the so-called built-in stabilizers.

A sizable deficit thus automatically occurs, and the necessary borrowing to cover it uses savings and expands credit.

This system does not demand an omniscient crystal ball in the Budget Bureau nor in the Halls of Congress. I conclude that this is the only realistic concept available, and that it should be used.

I have placed, Mr. Chairman, great emphasis upon the Federal Reserve System and its role. The Federal Reserve System is well equipped to help the private economy toward prosperity. It has long experience, and it is staffed with an extraordinarily skilled and competent organization of men and women. The Federal Reserve System is one of the most successful and commendable organizations the Congress has ever created.

The best budget policy is that which encourages the Federal Reserve System to be the Government's primary instrument to aid the private economy to achieve and maintain prosperity, which creates conditions most conducive to the efforts of the economy assisted by the Federal Reserve, and then automatically and rapidly provides aid when aid demonstrably is needed. That is the policy here advocated.

But while this statement has concentrated on budget policy for economic growth, I want to emphasize that even the wisest budget policy cannot assure the realization of the objective. There are a number of other essentials.

I should like to urgently recommend your attention to three aspects of taxation which seem to me to be of outstanding importance to economic growth.

1. Encouragement to American business operation and investment abroad, through special tax rates—

(*a*) To help maintain peace;
(*b*) To enlarge the domestic economy;
(*c*) To assure sources of materials needed here; and
(*d*) To reduce foreign-aid expenditures.

2. Facilitation of most efficient corporate operation. The tax structure contains a number of impairments and obstacles to most efficient corporate operation and these should be remedied. Among them, probably the most notable are the continued taxation of intercorporate dividends and the penalty on consolidated returns.

3. The third point regarding taxation that I would make is the need for realization of the fundamental relation of saving and economic growth. The penalties on the saving process which have crept into the tax structure need urgently to be exercised. Those who save—both persons and corporations—have already had to overcome the necessary obstacle of the payment of income tax, and furthermore they have had to undergo the penalty of foregoing the pleasure of current consumption of their income.

They benefit society by providing the wherewithal for economic growth, and as they must overcome an obstacle and make a sacrifice in order to save, the imposition of taxes upon the resulting savings is a most unwise tax policy.

Thank you, sir.

Mr. MILLS. Our next panelist is Mr. Edwin B. George, director of the department of economics, Dun & Bradstreet, Inc.

You are recognized for 5 minutes.

Mr. GEORGE. Thank you, Mr. Chairman.

I wish to join my colleagues in expressing my satisfaction with the direction in which the subcommittee has turned its efforts. I have

a feeling that the big tome itself will be a widely used reference piece for some time.

Any suggestions of immodesty in that remark seems to be adequately taken care of by the fact that there are some 80 contributors.

My objective is healthy growth, which to me means whatever rate of progress happens to attend a well-arranged system. I do not therefore go into a blue funk when prophets contend that the annual rate of rise in GNP is going to be only 2.92 percent instead of the 3.15 percent promised by other prophets.

I shall speak first of the revenue side of the budget and then of expenditures with exclusive attention to long-run growth. Then I shall relate the findings to stabilization.

LONG-RUN GROWTH

Taxation

The present structure is obviously not one that any government would plan or adopt intentionally. It has grown in response to evolution in ideas and social values, expediency, creeping progress in our knowledge of effects, and so forth. There are inequities at every point of the scale—high, low, and medium; interclass and intraclass.

We may have clung to some regressive levies partly because they were also indirect. At the other end of the scale we have nominally carried progression to uneconomic lengths but provided crude escapes. We have set up numerous good objectives but enact for them separately without enough regard at times for the effect on other objectives. I think that a steady focus on equity would serve all purposes reasonably well and dispose of most of the incongruities.

Not as a siphon for any given income level or revenue yield, but as properties of an equitable system, I would suggest the following for consideration:

1. Heavier reliance on personal income and estate taxes, including reduction of existing excises and integration of the corporate and personal income levies. The first conclusion not to be reached is that this is a revival of the misfit 1936 undistributed-profits tax. If certain other proposals in this tax package were not adopted I would oppose this one. Permitting closed corporations to file as partnerships would make a start.

2. Substantial changes in the personal income-tax setup, including withholding on dividends, income averaging, carryover of unused exemptions and deductions, significant reduction in the high upper bracket and corporation rates, heavier taxation of capital gains after income averaging, and other safeguards against substitution of new inequities for old, constructive realization on capital gains at death with somewhat similar safeguards, narrowing of tax brackets.

3. Extension of the corporate-tax carryback—say to 5 years.

4. Restudy of capital depletion with an eye to redrafting the compromise between equity and incentive.

5. Accelerating tax refunds.

6. Modernization of State constitutions and laws now cramping their borrowing and taxing powers and creating a partially spurious dependency on the Federal Government. Figure out some better way of splitting the carrying charges on State and municipal obligations between those entities and the Federal Government.

7. Provision of more funds for enforcement.

Expenditures

I think that the Congress has evolved over the years a very sound set of contributions to healthy growth. This may be as good a time as any for reappraisal and refinement.

Division of duties: Governments should not tackle any job which private agencies can handle adequately; the Federal Government should leave as much as possible to the State governments; and the States to local governments.

Slum clearance and urban redevelopment: On these programs I would place a premium in the interest of both a healthier society and a better political economy, with more vigorous administrative and financial participation by the States.

Public housebuilding: Federal participation should be limited to the establishment of standards and the provision of financial and technical assistance.

Highways: The earmarking of particular levies for highways seems to me an anachronism that we should outgrow; reciprocally, I would not rely so heavily on motor-fuel taxes for highway funds. The rectitude of pay as you go does not seem quite applicable to a vital service suffering from such gross arrearages.

Agriculture: It is in the public interest to protect agriculture from both natural and cyclical ravages, and the misuse of croplands. Controversial support mechanisms apart, there is an additional obligation on Government to (1) develop a better program for placing marginal farmers on their feet, and (2) facilitate movement to nonfarm employment of those actual or potential farmers who want to make the shift.

General assistance: In prosperity or mild recession lower governments should continue to carry the costs of general assistance. In depression the Federal Government should insure its maintenance at predetermined levels per person.

Old-age assistance: As it is still openended, the establishment of eligibility standards by the Federal Government seems to be overdue.

Welfare: In general, equalization among the States may have been overdone. In the aggregate something like a four-step inverse weighting is now laid on the higher per-capita-income States. It would seem that grants to States should be varied through allotment of funds or matching percentages but not both, and that per capita income should be computed after Federal taxes which in these days determine true income.

SHORT-RUN STABILIZATION

Adequate stabilization of activity is not only a necessary condition of healthy growth but is itself a major element of it.

I would regard as adequately stabilized a system in which unemployment is kept generally within a range of 3 to 7 percent of the labor force.

Our defensive weapons are automatic flexibility, so-called formula flexibility, and discretionary action.

Automatic flexibility is now strong. At the beginning of 1954 at least it was capable of blocking off about half of the cumulative effects of a serious initial blow to the system. Taxes have since gone down

but the liberalization of unemployment insurance and OASI have restored some of the strength thus lost. I would not make its further strengthening a prime determinant of policy.

I have cooled off on global formula flexibility. This would automatically throw into gear certain stabilizing tax and spending measures whenever certain signals flashed. But any signals that can be rigged up from available statistical series lack the precision and timing of such heavy duty. The effects of measures thus tripped into action could easily be perverse.

Selective formula flexibility is another matter. That means action in particular areas, such as construction, when either the area or general business (preferably both) sag too heavily. The Congress can do a number of things on a formula basis, such as making interest free loans to the States to preclude exhaustion of unemployment compensation reserves, underwriting general assistance payments at unchanged rates, and launching and supporting public works within moderate limits.

Automatic flexibility, because of missing pieces not wanted on more fundamental grounds, cannot forestall serious recession or depression, and it seems risky to attempt to handle all of any residual job through formula tax and spending setups or monetary policy. So the Congress will sometimes have to take over and set up its own blocks to the cumulation of a downturn on a discretionary basis. The most likely candidates for adjustment are OASI and personal income taxes—the latter preferably on merit, and good enough on timing if means are found to expedite refunds. Tax cuts to stem depression would not be the same as those permitted by a secular decline in the need for revenue.

I believe then that the actions necessary to maintain moderate stability would not injure growth and that the stability thus attained is necessary to growth.

Mr. MILLS. The next panelist is Mr. Everett E. Hagen, professor of economics, the Center for International Studies, Massachusetts Intute of Technology.

You are recognized for 5 minutes.

Mr. HAGEN. This is an important topic and we are all grateful at having been invited to participate and consider in it.

The present Federal tax system does a good deal to cushion recession.

Tax revenues fall in a recession even though tax rates remain unchanged. If GNP fell by $25 billion, and remained at the lower level for a full year, Federal tax revenues would fall by at least $8 billion, I estimate.

Because tax revenues fall in recession, recessions are not as severe as they would otherwise be. Consumer and business spending fall in a recession. But because tax liabilities fall, the decline in consumer and business income and spending is much less than otherwise. Thus the fall in tax revenues has a built-in stabilizing effect on income and employment which we cannot afford to do without.

Similarly, in an inflationary period, tax liabilities increase, and this reduces spending and checks the inflation somewhat.

In my written testimony I make suggestions as to which taxes do most to cushion swings in activity and what changes in the structure of individual taxes might be of some help.

These built-in effects as they exist now or as they would exist with the changes which I suggest or which might otherwise be suggested.

only reduce the depth of the recession. They do not reverse the recession.

From Mr. Woodward's testimony I gather that he would have budget policy do no more than reduce the depth of the recession and would have active policy left to monetary policy.

I must disagree with this. I think that we must have budget policy in some cases. To go further and make the tax system effective in reversing recessions Congress should provide for quick reduction in tax rates as soon as any serious decline in business activity occurs.

For example, if the first bracket income-tax rate were reduced from 20 percent to 10 percent in the event of a serious recession, consumers would be relieved of a considerable burden of taxes, consumer spending would increase, and the downtrend in employment might even be reversed, not merely lessened.

But to be both safe and fully effective, such a tax cut must meet two conditions. First, to be safe it should be made only if a recession other than a mere "inventory turnaround" such as that of 1953–54 is underway.

In late 1953, a reduction in business inventories caused a recession; this was the prime cause. There were, of course, some others.

In late 1954, an increase in business inventories reversed the recession and brought an upswing. If tax reduction had been enacted in 1954, it would have come into effect at the same time as the inventory upswing, and the two together would have tended to cause inflation.

In my written version I say they caused inflation, that depends on what other measures might have been taken. But it would have tended to.

To prevent such perverse effects, one safeguard is not to reduce taxes unless unemployment reaches a higher level than an inventory recession is apt to cause.

To reduce taxes only if unemployment reached at least 4,500,000 for 3 successive months would be fairly safe, for this much unemployment is apt to be due to more basic causes which will not reverse themselves quickly.

Another safeguard, if feasible—and this is so far as I know a rather new suggestion—would be to guide tax change by the nature of the recession. No tax action should be taken in a downturn due primarily to inventory reduction.

But provision could be made for tax reduction promptly—without waiting for unemployment to reach 4,500,000—if the downturn was due to more fundamental developments, namely, a marked decline in residential construction plus business expenditures for plant and equipment.

But distinguishing the cause of a recession in this way would be possible only if reporting on residential construction and business spending can be improved considerably, that provision was to make the action safe.

Secondly, to be most effective, a tax reduction must be made promptly, once a more serious recession is underway. For if it is delayed for say 6 months, after its need becomes apparent, the recession may have gathered a cumulative force which it would never have had if tax reduction had sustained income and spending in time.

Advance arrangement should therefore be made by law for quick change in tax rates in case of necessity. This would require legislation of an unprecedented type, providing for automatic reductions in tax rates when business activity fell off. I believe that such legislation is feasible and desirable.

One workable arrangement would be a law directing the President to reduce tax rates under certain circumstances specified in the law—for example, if unemployment exceeded 4,500,000 for 3 months, or if the rate of residential construction plus business expenditures on plant and equipment, expressed as an annual rate, fell by $5 billion.

The President should also be directed to raise tax rates again if a sufficient improvement in business conditions, as specified in the law, occurred. Another feasible arrangement would be a law deciding in advance the tax rate change to be made, and providing that Congress would trigger off the change by a joint resolution if the occasion arose.

This I take it, is what Gerhard Colm suggested in his testimony.

In any case, data on unemployment, prices, and business expenditures should be made more reliable than they are at present. Congress should make a considerably increased amount of money available for the purpose, in my opinion.

Mr. MILLS. We thank each and every one of you for the splendid summaries of your presentations appearing in the compendium.

I have a few questions I would like to ask.

The first one is directed to all of the members of the panel. Traditionally Secretaries of the Treasury, Budget Directors, and tax and expenditure committees of the Congress have stated that the major goal of fiscal policy is to balance the Federal budget.

But we have found that generally you can't balance the budget in a depression or even in a recession without reinforcing the depression or recession.

We have learned that budget surpluses in periods of inflation are helpful in absorbing excess purchasing power, thus stemming the rise in the price level.

Mr. Woodward states on page 2 of his summary that "the Government and the private sectors of the economy should operate in collaborative manner to assure that income and savings are maximized and that the best use of savings is made under all conditions."

Mr. George, Mr. Colm and other panelists have made similar statements.

Is there a general agreement that the old principle of balancing the Federal budget has given way to the broader goal? And if so, how can this broader goal be simply stated?

Mr. Keezer?

Mr. KEEZER. Well, I think you could find agreement in this group that the principle has probably gone the way of a good many important historical principles.

But I think we would misrepresent the total craft of economists if we did not indicate that there is an embattled group which holds that balancing the budget is the primary purpose of governmental tax policy.

In other words, I don't know anybody here who would argue that there is not occasion at times to have what has come to be called a compensatory budget policy. But I think we would not fully represent

the opinion of economists of good repute and perhaps even greater skill than we have if we did not say there is a difference of opinion.

Would that be correct?

Mr. HANSEN. I would rather doubt that statement. I would find it very hard to name any economist who would now and at all times defend a balanced budget.

I could not think of a single one, even a conservative economist.

Mr. MILLS. Dr. Colm?

Mr. COLM. Well, I could think of 1 or 2 but I want to be nice to them and not mention them. [Laughter.]

Mr. MILLS. Mr. Woodward?

Mr. WOODWARD. I think there is not necessarily a complete disagreement between the two.

My own position was for a budget that would be balanced over a business cycle, but not in each individual year.

It seems to me that it is important for economic growth to avoid a continuously unbalanced budget. It is important for the reason that Dexter Keezer referred to in the opening in noting what we have seen in the last 10 years; a very great price inflation. That has its adverse effects.

So while I agree with the proposition that none of us here and very few, if any, elsewhere advocate a balanced budget at all times, I don't want to go too far to the other side of the proposition.

Mr. MILLS. Mr. George?

Mr. GEORGE. I think that the two points that matter most in trying to answer a question like that have already been made. If you are thinking in terms of a poll, you have the slight divergence of views between Mr. Keezer and Professor Hansen.

I would aline myself a little more closely to Professor Hansen. I would not quite go so far as he did, however, because I think you can find a few stubborn economists who will not yield an inch of that ground.

I think that Dr. Woodward put his finger on the real problem as it originally shaped up and that was to balance the budget over a cycle.

That has not really worked out, and I think a realist would not quite expect it to.

As a matter of fact, a wag said the other day, I think it was Professor Bachman of NYU, that the policy now reads when in depression you run a deficit and when in prosperity you run a deficit.

One difficulty of course is the very size of the Government. With a government like an elephant in the water glass at the present time and with a budget so large it would be preposterous to insist on balancing it every year, regardless of circumstances.

And I doubt if any administration would try to do so.

Mr. MILLS. Mr. Hagen?

Mr. HAGEN. It seems to me that the difference among economists now is not so much on the question of annually balanced budgets, but on the question of whether tax rates should be set at what seems to be a desirable level and then left alone so that revenues fluctuate during a cycle only because of the change in the level of business activity, or whether tax rates themselves should be changed over the cycle.

Another point should be noted. When we talk about whether the budget is or is not balanced, we may be talking about the conventional

or administrative budget. On the other hand from the economic viewpoint the so-called cash consolidated budget is more important.

For example, suppose the conventional budget as presented to you gentlemen shows a slight deficit this year.

It is undoubtedly true that even so the cash budget will show a small surplus, and if the conventional budget is balanced, as it may be, the cash budget will show a considerable surplus. So that you have got to consider which budget you are talking about. But whichever one you are talking about, I think the issue among economists now is not the one you cite, namely, whether the budget should be balanced annually, but rather whether tax rates be left alone or should be varied during a cycle.

Mr. MILLS. Actually, it occurs to me that all of you are in fairly close agreement, that although balancing the Federal budget may be a primary requisite, perhaps for the Bureau of the Budget, and the Secretary of the Treasury, the Congress should not lose track of the importance of balancing the national economy, or dampening fluctuations in the level of economic activity, whichever way you desire to describe it.

Now is that about the situation?

Mr. KEEZER. I think it would be a splendid thing to have six economists to attest that they do agree in general on that proposition.

Mr. MILLS. Dr. Colm, perhaps as one of the originators of the concept of the Nation's economic budget, which has appeared in the President's budget and economic report since 1945, you would give us a brief explanation of it.

What do you mean by balancing the Nation's budget?

Another question: When would you have imbalance?

What kind of imbalances are there?

What are the ways of restoring balance?

Mr. COLM. Mr. Chairman, I feel flattered first by the reference to the contribution I have made among others, to the development of the so-called Nation's economic budget; I see others here present who had a great deal to do with it.

I also feel challenged by the assignment you gave me, and I guess I have less than 5 minutes on that.

Let me respond to the first part of your question: what is this thing which has been called the Nation's economic budget, or, as far as periods of the past are concerned, should perhaps more accurately be called the Nation's economic account.

Mr. Chairman, I suggest this is nothing fundamentally different from what every corporation needs when there is a discussion about how changes in prices or changes in wages or other changes affect the enterprise?

Well, before long somebody will ask, what does that mean for our profit and loss statement, or how will it be reflected in the balance sheet?

We know that on one sheet of paper we cannot say everything that characterizes an enterprise.

But you do need something which gives you the highlights. I suggest that the Nation's economic budget serves basically the same function with respect to the whole economy. We know it does not reflect everything.

There are lots of other indicators which we need. We need data on prices and wages and costs and many other things. But if you want quickly to measure how a certain event affects the whole economy—for example, tax reduction or a change in international trade, the Nation's economic budget gives you on one page the highlights which emphasize the changes that have ocurred in the various sectors of the economy, the consumer sphere, the business sphere, government, and international transactions.

It demonstrates economic interrelationships. When businesses change their investments that affect consumer income through wages, it also affects governmental revenues and influences a host of other economic factors.

When consumers change their willingness to buy, perhaps on installment credit, this too affects the various sectors in the economy.

Mr. Chairman, I submit that that is what the Nation's economic budget shows us in a simplified manner.

It gives us an idea of how changes of the past have affected the various sectors in the economy. This gives us a basis for appraising the likely economic effects of changes in the future.

I don't know whether that is an adequate answer to the first part of your question. Do you want me to go on to the second part of your question?

Mr. MILLS. I had in mind also that you would discuss when you would have an imbalance in the Nation's economic budget.

What kind of imbalances are there that you refer to?

Mr. COLM. Mr. Chairman, very broadly speaking we have situations in which private demand, either for business or consumer spending tends to exceed potential production. In such situations prices tend to rise.

Now I would say that in such a situation you would not reduce taxes, and would not set up Government expenditures except by also increasing taxes. This is a situation in which you would try to obtain a large surplus in the consolidated cash budget.

We also have situations in which business expansion may slacken, and in which consumers, perhaps, temporarily saturated because they have bought so much may not increase their expenditures. In such a situation, the demand by business, and individuals may tend to fall below the potential output of the economy. This is a situation in which the Government could enact tax reduction or if there were a worth-while public works in store, the Government could now go ahead with these projects on the expenditure side, thereby causing a cash deficit and a certain amount of borrowing.

These are the criteria for tax policy which would take into consideration the general effect on the economy.

Now, this is where there arises the differences of opinion to which Mr. Hagen referred, because some people think that we should rely only on the changes in revenue which come about automatically.

That is an example of the so-called built-in stabilizers. Mr. Chairman, I submit that everybody agrees that the built-in stabilizers have given greater shock resistance to the economy. I think we can all agree on that. But some of us, and I include myself, go beyond that point.

I can't see how the Government, in the face of a serious economic situation, could just sit by and remain inactive while relying solely on the built-in stabilizers.

Even in the mild recession of 1954 tax reduction helped us to stimulate the recovery. And I think in every future situation the Government will do the same thing. I agree that tax reduction is not the only tool we have; it is only one of the means of a stabilization policy.

I think that the Employment Act has given the Government a responsibility to use all available means for counteracting serious fluctuations. And certainly among those, in my judgment, are changes in the tax rates.

The Employment Act demands that Congress reconcile the objectives of stability with other objectives with which we are concerned; the soundness of credit, for instance, is one of these other objectives.

And I don't see why there need be any necessary conflict between them. I also agree that there are other devices than the budget. We should recognize the usefulness of monetary policy. However, I think Mr. Woodward puts a little bit more trust on that than I personally would do in periods of slack, although it is a useful instrument for mitigating a boom.

One further point which has not been mentioned, Mr. Chairman, is that the budget reflects only part of Government activities. There is today a tremendous influence on our economy resulting from Government guaranties, from insurance, and so on. These are activities influencing, for instance, residential construction, and these activities are not reflected in the budget.

I think that whenever we talk about the budget we should in a way also include these other aspects of Government operations. Thus the budget is not the only thing; it is only one instrument among many. In this respect the Employment Act has great merit in that it does not focus its attention only on one instrument of policy, but on all that are available.

Here we are concerned mainly with tax policy and I would submit that tax changes adopted at the proper time can make a significant contribution to economic stability and sustained economic growth.

Mr. MILLS. If we depart from the concept of balancing the Federal budget to this broader concept, how would we know exactly when to increase or decrease tax revenues?

Professor Hansen, do you desire to comment on that?

Mr. HANSEN. Well, I think, Mr. Chairman, that Dr. Colm has already indicated in a broad way the answer to that question.

I think that the instability is primarily indicated by changes in price level, inflation or deflation, and unemployment. And if you have unemployment increasing, which may be accompanied or may not be accompanied by a fall in prices, then you have a strong indication that the Federal Government should take positive action—budget and monetary policy—to bring the economy back toward full employment, toward price stability. Similarly, the other way, if you have unemployment reduced to a very low level and inflation occurring, then you have a signal for an increase in taxes and, if possible, a reduction in Federal expenditures.

So I would say these two are the primary criteria—employment developments and price developments.

Mr. MILLS. Professor Hansen, I was concerned as to whether or not we might be dependent upon economic forecasts for making this determination, or would we have programs ready, and then expect to take action on those programs when economic trends of this nature became evident?

Mr. HANSEN. Yes, that is a very great difficulty. We should certainly try to improve our forecasting, perfect it as much as possible, and I think very much can be done and I think a great deal of research is going on to improve our forecasting.

I am one of those who believes that we never shall be able to forecast with any high degree of accuracy. But I think we should nevertheless try to improve our methods in that direction.

You mentioned the importance of having plans ahead of time. I think that is enormously important, to have plans prepared both on the tax side and on the expenditure side, public works and planned program of tax reduction if that should turn out to be necessary. The program should be on the books, be available at any time, to be used without long debates beforehand.

Then I think what is very important here is not to be too afraid that a mistake is being made.

In other words, what is very important is to be prepared to reverse your action in the event it turned out that the decision that was taken was really a wrong one. All kinds of things can happen in the kind of a world we live in which is one subject to change in all sorts of directions.

We never can know whether what seems to be a correct short-run forecast now is really going to turn out to be correct. So I think it is very important to reverse the policy if we find a mistake is made.

I should say that the announcement that the Government is prepared to reverse its policy would be enormously important because the impression should not be given that the Government doesn't know what it is doing, flopping around from one thing to another. The Government should announce a policy of being prepared to reverse its actions when that is found necessary. Unless we can educate ourselves to that point, I am afraid we will always come in with too little and too late.

Mr. MILLS. I understand Senator Douglas has a question to that point.

Senator DOUGLAS. I would like to address a question which I suppose is primarily designed for those who believe that the general tax rates should be reduced; that is, to those who believe that rates of taxation should be reduced in a period of economic decline or that expenditures should be increased, or both.

The question is this: What percentage of unemployment would you take as the critical figure to justify either a decrease in tax rates or an increase in expenditures or both?

I wonder if we could have an expression on that.

Dr. Hagen proposed an absolute figure of 4½ million which is approximately 7 percent of the working force. And allied with this is another question I should like to raise, that is, whether we should consider solely complete unemployment or whether we should also take into account involuntary part-time unemployment?

Dr. Hansen would you be willing to start off?

Mr. HANSEN. Yes.

I would include the part-time and involuntary unemployment. I think that is important. I would be afraid that Dr. Hagen's 4½ million is far too big.

Seven percent unemployment, oh, if the economy has reached a point of 7 percent unemployment, and no action is taken until that time, it takes some time before any action really becomes effective. Already, you may have a cumulative process at work even though it were actually taken at 4½ million, which would drive unemployment up to say 10 percent.

I think the action should be taken much earlier than that.

Now, it is difficult to fix upon an exact figure. I would only say that 4½ million in my judgment is far too high.

Senator DOUGLAS. That is 4½ million of totally unemployed.

Mr. HAGEN. Totally unemployed.

Senator DOUGLAS. If you included part time——

Mr. HAGEN. Including part time——

Senator DOUGLAS. It might come to something a little less than 5 percent of total unemployment.

Mr. HAGEN. Yes; 5 percent, I would say, is also too high.

I would like to give a little thought to what I would put down as a precise figure. I would only say that that figure is much too high.

Mr. KEEZER. Do we have a historian here?

Wasn't unemployment up to about 4¾ million in 1949?

So if we had used the formula suggested at that time, wouldn't we have lowered taxes and found ourselves touching off a much larger expansion on the rebound?

Mr. HANSEN. Could I make a point there?

We did have, I believe it was the first quarter of 1950, a tremendous increase in transfer payments. It had to do with the veterans. It was not a small coin at all; it was an enormous increase that happened to come at that time.

Now, that was extraordinarily useful and was really the thing in large part that set off recovery before Korea came. If at that time we had deliberately increased expenditures for that amount, it would have been exactly right.

Mr. MILLS. I am not a historian, but I do recall that when this downturn occurred in 1949 the Ways and Means Committee began consideration of tax reduction, but before the legislation could be finally enacted by the Congress the Korean conflict arose and it was necessary for us to change the trend to tax increases. We did increase taxes in 1950, finally.

Mr. Woodward, I would like to ask this question of you, if I may. Does tax policy aimed at stabilizing the economy have any adverse implication for growth? What I mean by that is this: Are there any differences actually involved in policy aimed at the two objectives of growth and stability? Can you have both in the same tax policy?

Mr. WOODWARD. I think this arises from my previous comment, if I understand you.

Mr. MILLS. That is right.

Mr. WOODWARD. They will not, I think, be at all times mutually consistent, and our problem is to write a compromise in between as I would see it.

We want growth. We don't want to create conditions in which there will be extreme inflation over a period of time.

There will be times when we would have more growth, I presume in the short run by larger Government expenditures, and an unbalanced budget. But in this matter of growth we have to look not only at the shorter run but at the longer run. Therefore, I think you are quite right in suggesting that we may have to compromise the two objectives on specific occasions.

Mr. MILLS. Well, is it possible to formulate a policy to meet our stabilization objectives and prevent a conflict between the two objecttives by providing, at the same time, for the attainment of some one of a wide range of growth objectives?

Mr. WOODWARD. Well, the position I took in my testimony, sir, was as near a compromise as I have been able to evolve in the practicalities of the situation.

If we could forecast accurately, then there would be no problem in this matter. And it seems to me, that that is the point which most of the panel have confronted without a satisfactory answer so far this morning.

I have along with other members of the panel engaged in a good deal of work over a great many years in trying to forecast and improve our methods of forecasting. The fact is that in reading these economic lines at any given time there isn't any certain way to tell whether a movement in the line is a jingle or a change in trend.

We have to live in that kind of a world with that kind of implacable fact in front of us. That is the reason for the need of a compromise, as I see it.

Mr. MILLS. Why, actually, does the attainment of these objectives require compromise?

Mr. WOODWARD. Because, fundamentally, I believe, the creation of inflationary conditions do not become immediately obvious or immediately operative in the short run. We saw in the war an extreme example of that, where we had controls underway and we had a very large expansion in the money supply, and thus conditions of inflation. Both controls and monetary expansion were necessary. I was in the Treasury Department at the time, and I think there are few apologies to be made. But the point was that a head of steam was built up in the monetary supply at that time, which resulted in the condition that Dr. Keezer called in the opening of this discussion an adversity, an extreme adversity that we experienced in the 10 years after the war.

Mr. MILLS. Mr. George——

Mr. KEEZER. Mr. Chairman, would it be helpful at this juncture to define just what we mean by stability?

Mr. MILLS. For the record, I think that would be very helpful, yes.

Mr. KEEZER. In my conception you can have a stable economy and at the same time an economy which is growing very fast. It is growing with only relatively slight deviation from a line of steady growth. I am not sure that is the general conception here.

That would be my conception of what we mean by stability. So conceivably you could have a very fast growing economy and you also could have a very stable economy. But it would be more or less of a fluke if it happened that way. Because, the very process of growth is disturbing. New plants are built, new people come in and take new jobs, new processes come in, companies go broke. But conceivably, you could have both, you could have a very rapidly growing economy

and a stable economy, with the many disturbances caused by growth offsetting each other.

Is that concept agreed upon generally here?

I think it is fairly important.

Mr. MILLS. Is there agreement that that is the objective, that that is what we mean?

Mr. COLM. Mr. Chairman, I agree, but I would like to make quite clear what I think Mr. Keezer means, and what I agree with: That stability means what might be called balanced economic growth. That means an expansion in line with the productive resources. But it also means a reasonable stability of prices. I do think that both these concepts are involved. Reasonable stability of prices, however, does not necessitate absolute stability, nor does stability in the employment of resources mean absence of fluctuations of a minor degree. But I would define stability with respect to both prices and employment of resources.

Senator DOUGLAS. Perhaps you covered this. I would say in addition to (*a*) stability in production to which Mr. Keezer referred, and (*b*) stability in price levels to which you addressed most of your remarks, that there should also be (*c*) stability of employment, or substantially full employment, so that we should have, in my judgment, a triple test and not a single or a dual test.

Mr. COLM. I agree entirely with what the Senator said.

When I said employment of resources I meant both—as a matter of fact, I mean mainly human resources, because I don't know that we will ever fully use up all our material resources.

Mr. MILLS. Mr. George, in view of the difficulties you noted about getting agreement as to when discretionary or explicit stabilizing action is required, shouldn't we put a very high priority on increasing the tax system's built-in flexibility in order to reduce the necessity for relying on special measures?

Mr. GEORGE. Not particularly.

I would not regard the attainment of flexibility or the strengthening of what I called the cyclical snubbers in this system as being a prime objective in itself. I am pleased that matters have so developed over the past several decades that without any planning to that end at all we have come out with a lot of properties in the system that work automatically against the departure from some desired level.

As evidence from my own text I am inclined to put my first emphasis on equity with a growing conviction that most of the other considerations will be reasonably served thereby. I would like to add, if I may, to the discussion that has just taken place as to the timing of action.

I think that the question that Senator Douglas asked was a reasonable sequel to the one that you asked. And it throws us all, we haven't answered it. I don't particularly want to answer it. It is the dickens of a job. You can have portents of a storm that will look like we are growing straight to the cellar, and it will turn out to be a mild blow.

You can have, on the other hand, deceptively mild signs of breakdown in the system, and it will turn into a 1929–33, and did. We made an effort up in our little shop some time ago, we tried very conscientiously to derive a set of signals out of all the statistical series that

would tell us just when to act. We went into that with high hopes and came out drooping. We couldn't do it.

I don't want anyone to start throwing around the delicate bric-a-brac of this economy as far as I am concerned to maintain a very tight system, with resources "overemployed." I don't want anyone to rely on my forecast in doing so. I guess I have been about as lucky as the average. These things are very difficult. We set up a set of six tests that any signal, as we call them, actuators ought to meet. And we went all through the series that one could think of: the normal ones, Federal Reserve production index, BLS, various combinations of the wholesale price indexes, personal income to which Professor Hansen referred, unemployment series and all of them trip you.

To explain why they will all trip you would be a very long answer. I won't attempt that. But I would like to stress this: That I believe firmly in the responsibility of the Government to prevent wide fluctuations in the system. I think, however, that there is going to be much more misallocation of resources and perverse timing than if you take as bases for that action the criteria advocated by Professor Hansen than if standards are adopted more closely approaching Professor Hagen's.

Mr. MILLS. Mr. Keezer, may I ask you what standards we should use to measure whether investment is adequate?

Are there any standards that we can use?

Mr. KEEZER. I think you can use the standard of employment of that section of the economy engaged in producing and installing capital equipment which provides employment for roughly 25 percent of our industrial employees.

Whether you are making relatively full use of the new products, new facilities coming out of the research laboratories which Mr. Hansen has stressed—I should think that would be an important test of the adequacy of investment. Over this postwar period we have had a general satisfactory level of new investment. That provides an historical standard which could be applied.

In the context of this hearing, I should think one of the main tests would be the extent to which investment is contributing to stability or instability in the economy.

I think we have far greater success in getting stability if we attempt to stabilize investment at a high level rather than waiting for it to go down and trying to do something about it thereafter. I have little faith in these arrangements which seem to imply that we can let things fall apart and then somehow we will pump them up again. Things are going very well. I think the emphasis would be on maintaining this state of affairs rather than going in for all these automatic devices after we assume things have fallen apart.

There is no occasion for them to fall apart.

Mr. MILLS. How do you reconcile your recommendation that corporate tax rates should be reduced with your recognition that we must have a balance between investment and consumption expenditures?

Mr. KEEZER. I am not aware that I recommended a decrease in the corporate tax at this time.

Mr. MILLS. In your main presentation?

Mr. KEEZER. I don't believe I did, Mr. Chairman.

I said that over the longer run we would find it extremely difficult.

Mr. MILLS. You were speaking of the long run?

Mr. KEEZER. Yes. I think we have at the present time a high and satisfactory level of business investment. There are also questions of equity that have been mentioned here. But simply in terms of maintaining an adequate level of investment, I would not say that the present time is an occasion to reduce the corporate tax rate. Except, may I give this qualification? Maintaining this rate means that you are going to have larger and larger corporate units at the expense of smaller units. This seems to be a matter of great social, political, and economic importance. Over a period with which we are concerned, the smaller corporations, as you well know, have not had the same rate of growth and capital acquisition. That doesn't mean that over this period there has not been a high level of capital investment as a whole.

But I did stress in my statement, and I would stress again, we have had extraordinary stimulants for capital investment. We have had first enormous postwar backlogs of demand, and we have had Korea, and so forth. I expressed concern and I continue to express concern, that over a longer period of time a rate which takes over half of all corporate incomes above $25,000 will not be compatible with the maintenance of a high level of business investment.

But I make no specific recommendation as of this moment.

Mr. MILLS. Since you raise that point, I am led to ask the question: Are you saying, Mr. Keezer, that our present tax policy is more conducive to investment in larger business ventures than in small business ventures?

Mr. KEEZER. What I am saying is that overall during this period with which we are concerned we have had a high level of capital investment. We have promise of a high level of another year. I think if you look at the total mix of business concerns, the smaller corporations, business units have not been as successful in growing, and for fairly obvious reasons.

Mr. MILLS. Is it your opinion that that fact may be due in part to the present tax law?

Mr. KEEZER. I think that is—well, I can't demonstrate it indisputably but I should think it is clear. We do have that long period of excess-profits tax where obviously the corporation with the large tax base was benefited. The small growing corporation—the small corporation, successful and trying to grow—needs money. If there is a necessity of giving over half of it to the Federal Government, it doesn't have the money with which to grow. I think it is as simple as that.

Mr. MILLS. On page 2 of your summary, Professor Hagen, you said "If tax reduction had been enacted in 1954, it would have come into effect at the same time as the inventory upswing, and the two together would have caused inflation."

I wonder if you recall that in 1954 we did reduce taxes altogether by about $7,400 million?

Mr. HAGEN. I realized after I said that, that it was elliptical.

Certainly one of the reasons that the recession did not go farther was the tax reduction which was already in the works, quite apart from the recession.

What I meant was that if, in the middle or fall of 1954, additional tax reduction had been enacted specifically directed toward the recession, it would have had an excessive effect. I simply reduced my statement too much to be clear.

Mr. MILLS. You do consider that those reductions which went into effect had the effect of reversing that downtrend and causing the upswing in the following months?

Mr. HAGEN. Yes.

Mr. MILLS. I am not trying to lead you into saying that they were the cause.

Mr. HAGEN. I understand.

Mr. MILLS. But that they contributed to that?

Mr. HAGEN. There were a number of joint causes.

Certainly those tax reductions had a notable effect in leaving more income after taxes to individuals and business and increased expenditures.

In addition, there had been a reduction of inventory since 1953 and 1954, because they seemed too high.

There was a reversal in that, business began to start up again. Those two things combined undoubtedly were the major forces at work.

Mr. Chairman, I hope some time before we finish this panel we will go back to the discussion of when tax rates should be changed, the point Senator Douglas made.

Mr. MILLS. Other members of the subcommittee will raise that point I am sure.

Now I have a final question and I would like to have some comment from each panelist if I may. Applying all the economic principles and criteria we have been talking about this morning, what bearing does the present and prospective levels of economic activity have on whether it would be wise to legislate tax reductions next year?

Senator DOUGLAS. You mean a net reduction in taxes?

Mr. MILLS. A net reduction in taxes. You anticipated my question.

Mr. KEEZER. Well, that involves of course the forecast on the state of business in 1956. In my judgment we will continue through the year at a high level and not be under the necessity of compensating for shortage of purchasing power which I take it is the idea under discussion here.

I should think it would be most unfortunate if politics intervened and we had this year a political tax reduction designed to please people about to go to the polls.

Now it can be argued that our taxes are so high already that reduction at any time is both desirable and it is really preposterous to talk about a danger of tax reduction.

But in the context of the discussion here, and insofar as tax reduction is regarded as a means of equalizing and stabilizing consumer income, I believe none will be called for during the coming year and if it is enacted it will be the result of, shall we say, political calculation?

Mr. MILLS. Let me throw out this additional question?

Then I would like the panelists, if they will, to discuss the two together.

The second question: How can the Joint Committee on the Economic Report, best contribute to the consideration of tax policy in the next session of Congress?

First, do the facts justify tax reduction next year?

Second, what can this subcommittee do to contribute to tax policy in the coming session of Congress?

Mr. Keezer, if you will pick up on the second question, what can this subcommittee do?

What recommendation do you have to make to us, that we follow?

Mr. KEEZER. Well, I have not been altogether modest thus far but I am too modest to try to advise this subcommittee on what it should do.

Mr. MILLS. I am asking the question because normally, and I should say as a matter of due course, if any tax reduction occurs it will be considered first by the Ways and Means Committee of the House, and second, by the Finance Committee of the Senate and then by the President, if he desires to sign or veto.

But in the light of this historical matter of jurisdiction of the two committees in tax matters, I am trying to get some advice as to what the Joint Committee on the Economic Report may do to help formulate tax policy for next year?

Mr. HANSEN. Well, Mr. Chairman, in your first question I would say that at the present state of economic development in the country, I would say if there were a choice between nonmilitary expenditures, schools and so on and tax reduction, I would leave taxes where they are and undertake these very much needed nonmilitary expenditures.

If it were true that we are pretty sure that the economy was really moving into very high gear, I am not sure we are really sure of that yet, then I think there might even be a case for increasing these very much needed nonmilitary expenditures, and increasing tax rates.

But I am not clear myself that that would be necessary. I would say that in my view with the present conditions that now appear reasonably clear in the short run, I would plump not for tax reduction but an increase in the very much needed nonmilitary expenditures.

Mr. MILLS. Professor Hansen, am I wrong in thinking that during times of peace, such as we now have—and certainly we are prosperous—should we under such circumstances give some consideration to the question of applying any possible budgetary surpluses not only to increase services, not only to tax reduction, but also, perhaps, to a reduction in the amount of the public debt?

Mr. HANSEN. Well, I am not quite in dead center on this particular issue as people around the table well know.

I would not at any time be primarily concerned with either the size of the public debt or the balancing of the budget even in high periods of prosperity. I would be concerned with the question whether that high period of prosperity might not be severely damaged by trying to build up a surplus and reducing the debt.

I would think that would be much too high a price to pay.

Mr. MILLS. Under what economic conditions Professor Hansen, would you say that we would be justified in giving primary consideration to the application of budget surpluses to a reduction in the public debt?

Mr. HANSEN. In a period of inflation. Apart from that I find it rather hard to visualize the need to reduce the debt. If an economy is growing and stable, I see nothing wrong with some growth in the public debt.

Mr. MILLS. Is one of the virtues of balancing the economy through the business cycle that it provides the opportunity in times of peace and prosperity of paying debts created in times of downturn in business activity or periods of war?

Mr. HANSEN. I am quite prepared to have a big surplus if that is necessary to prevent inflation in a boom period. I am quite prepared for a big surplus and drastic debt reduction if that is required to maintain stability. If it is not required, then I would not be prepared to have a balanced budget. I would maintain high and stable prosperity and full employment rather than threaten that prosperity by applying the dogma that we ought at such a time to be cutting down the public debt.

I am afraid that might be the very thing that would cause the end of the prosperity.

Mr. MILLS. Well, at least I think it is agreed by the panelists, is it not, that the present economic situation and a continuation thereof does not suggest that primary consideration should be given to tax reductions in the coming year?

Mr. HANSEN. Yes, I think that is right. We probably will have some as Mr. Hagen has indicated, we probably will have some restraining influence here from the cash budget, which is the one we must really consider from this standpoint.

That is to say we will have a surplus in the cash budget, in other words we will have from the budgetary side a restraint on the economy this year.

It is very important to remember that. Even though the conventional budget is out of balance. The actual economic effect of the budget will be a restraining effect to the tune of 2, perhaps 3 billion dollars.

Mr. MILLS. I am talking about a reduction in receipts to the Government. There might be, and I understand there possibly will be, some legislation resulting in some changes——

Mr. HANSEN. In the tax rates?

Mr. MILLS (continuing). Among different groups. I understand there is a possibility of such legislation being suggested to our committee from the Treasury Department.

I don't know how extensive it would be. I am not committing them to a position of reducing taxes. But it is my information there is some work being done on the tax situation.

What I am talking about, however, is tax legislation that has the effect of a net reduction in revenues.

Mr. KEEZER. Shouldn't we take on just a little less territory here?

We are talking in terms of growth and stability. And I would say that so far as I am concerned I see no occasion in the immediate future for a tax reduction in those terms.

I am not broadly enough familiar with the tax structure, all the ins and outs to pass judgment on it, but only in the broad context we are using here.

Mr. MILLS. That is the context in which I put the question. I would like to ask this additional question of you: Since in your opinion the present economic situation, if continued throughout the next year, does not justify tax reduction, are there indications that the present situation justifies a reduction in public debt, if surpluses are developed?

Or should those surpluses be applied, if not to tax reduction, to new or larger services of the Government?

Mr. KEEZER. If I felt my thumb, I probably, in deference to my training, would say reduce the debt.

But I have not thought enough about that particular problem to feel that what I would have to say would be worth listening to.

Mr. MILLS. Professor Hagen?

Mr. HAGEN. I would like to be so bold as to suggest what this committee might do with respect to this, even though the rest of my colleagues are too modest. My suggestion is very simple.

First let me say, concerning the first of your two questions, it seems to me that the ideal course of procedure is that the Congress and the President decide first how much the Federal Government ought to spend, because the expenditures are desirable and necessary for their own sake, not to sustain employment.

I would think, for instance, my private personal opinion, that some increases in military expenditures as well as in nonmilitary expenditures are called for.

If that is true, if they are needed in the interest of the national economy and the national society, then they ought to be made.

Then the question is, What taxes do we need in the light of those expenditures?

I do not mean, What taxes do we need to balance the budget? In the light of those expenditures, and in the light of level of the private spending that is anticipated, how high taxes do we need to balance the national economy?

In other words, to restate this: What the tax level should depend upon is (1) the level of public spending, and (2) the level of private spending. And if the level of public and private spending combined are so high that they are apt to produce inflation, then we ought to raise taxes.

If the level of public and private spending combined are apt to leave unemployment, then we ought to reduce taxes.

Now I would think that what this committee might well do in connection with tax legislation consideration next year is to try to bring prominently to the attention of Congress as a whole the need to consider this national economic picture, rather than merely the Federal budget, in deciding on tax legislation.

After all the function of this committee is to consider the national economic picture, and it seems to me the one obvious direct thing that this subcommittee has the responsibility to do is to stress to the rest of the Congress that this national economic picture must be looked at.

Assuming, of course, that this subcommittee agrees that this is a proper analysis.

Mr. MILLS. Yes, Mr. Woodward?

Mr. WOODWARD. I would like to respond to one part of your question—that on the national debt.

It seems to me that this is the time to reduce the national debt if we are ever to reduce the national debt.

And I personally have not reached that stage of equanimity that my friend, Dr. Hansen, has reached—that it never need be reduced.

I said I was in the Treasury during the war and I have regretted very deeply what seemed to be the necessity to rob the widows and the orphans and the beneficiaries of life-insurance policies. I regret it very much. But it was a function of war. I see no reason why we should in any fashion rationalize that kind of procedure in other than the extreme exigency of war.

Dr. COLM. Mr. Chairman, I will try to respond to your two questions.

First, is a tax reduction, as it now appears, justified?

Second, what advice would we give to your committee? I am immodest enough to try to answer both questions.

As a matter of fact, the first question I have attempted to answer in my testimony. And I had to write that as you know, Mr. Chairman, 3 months in advance.

At that time I was very uncertain in my own mind when I came out with the conclusion that this is not a time for tax reduction. In the meantime I have become more certain that this is the proper advice to give as of this moment, for the following reasons: First, I wrote my testimony before I had the benefit of Mr. Keezer's survey-of-business intentions with respect to investment in plant and equipment.

After those figures came out I was more certain that my advice was justified.

Second, I wrote my testimony before the second Geneva Conference had been held. We were still under the spell of the summit conference. I wrote that I thought defense expenditures in 1957 would not go down but rather may rise a bit above the level of the current year.

At that time some people who read my testimony commented that this was not very reasonable since we seemed to be moving toward demobilization.

I felt, however, that this would take a longer time. I hope that the expectations connected with the summit conference will materialize, but I feel certain that it will take a much longer time. Meanwhile, costs have gone up and unless we curtail the Military Establishment expenditures will go up at least somewhat.

With respect to the nondefense expenditures I am impressed, as are the other members of this panel, by the need to develop certain very urgent programs.

As a matter of fact, I have recently calculated that the Federal Government is spending per capita for all purposes, excluding national security and war liquidation, 30 percent less today than it did in the fiscal year 1940, the last year before the Second World War.

That is expressed in constant dollars. It is true that State and local government activities have gone up. But there is no growth in these public services commensurate with the increase in the standard of living and the increase in general economic activity.

And yet, even if we move as promptly as I wish we would, the effect on the final 1957 budget will be relatively small because it always takes time to get into these new programs.

Therefore, I assumed a higher budget in fiscal 1957 than in 1956, but only moderately higher.

Under those conditions, and considering the present economic outlook, I reached the conclusion that this is not the time for an overall tax reduction. I am talking here as the chairman wanted us to talk, in terms of overall revenue. That by no means contradicts the possibility of certain changes in the tax laws and improvements in the tax structure.

I come now to the second point, the second question the chairman asked: What advice do we give to the subcommittee?

My advice to this subcommittee—and I say it without hesitation—I mean I have all the modesty inside but I try to overcome it and say bluntly what I think.

My net conclusion is this: If I were in the position of advising the joint committee, I would advise not to put the greatest emphasis on what I have just said—on what to do or not to do next year for a very simple reason. The reason is that I may be wrong.

This is the economic picture as I look at it and have been looking at it over the last 3 months. But the economic outlook may change and sooner or later is likely to change. I think it is much more important for the joint committee to go on record with a statement of principles, with a statement that after we have looked at the expenditure side and after we have looked at the economic outlook side, then we should reach such-and-such conclusions.

I recommend that the joint committee goes on record as saying that we are concerned not only with the objectives of sound credit—which we are, and should be—I don't want to disagree with that emphasis—but that the foremost concern should be with stabilization in the double meaning, avoiding of inflation and avoiding of a contraction.

I would also say, that there is no—and I think I am a little bit critical of what my friend Mr. Hagen has been saying—no single indicator or selected group of indicators which will always tell us when we have to act or not to act.

We have to look at the whole economy. No physician can give you a diagnosis by looking only at the blood-pressure gage, or the thermometer or by simply listening to his stethoscope.

He has to look at the patient as a whole. In one situation I would be concerned with an increase in unemployment, let's say, from 1 to 2 million, and in another situation I would not be concerned if we have 3 to 4 million unemployed. It depends entirely upon what our analysis of economic development shows. I don't think that in such an economic analysis we are relying quite as much on what has been called crystal gazing, because a great deal of the future is decided in the past. The business intention surveys, consumer surveys, the very interesting survey of expectations of businessmen in Dunn's review, and so forth, all these are measurements of what is now on the mind of people who make decisions which affect the future. Also the budget is something that is decided in advance, even though it might be subject to changes.

I would advise against putting these criteria in mechaninstic terms of a definite barometer. I would look at all the elements in the Nation's economic budget and all the forces which we now know are influencing economic trends in the future.

Further, I want to say that—and here I agree with what Professor Hansen said—we should decide what we think are the best lights at the moment, even though we recognize the possibilities of change.

At this moment I don't see a collapse in the economy in sight. I could make a point why I think that certain developments are unsound. I think we are building up trouble in certain respects. But I am not sure enough of the timing of such possible trouble to base any present recommendation for immediate action on that.

But if symptoms appear that the economy is faltering then we should change tax policy as promptly as we did in 1950.

At that time, under the impact of the recession, a tax reduction was contemplated by the House committee. Then the outbreak of hostilities in Korea took place and a tax-reduction bill was changed into a tax-increase bill. I think that this experience proves the feasibility of prompt action, and if I am correct the joint committee had something to do with that quick change.

I think this is not an illustration against fiscal policy but for fiscal policy.

And similarly I could imagine that a new situation may arise next year. But for the time being I would be guided by what appears now foreseeable. This leads to the advice: Don't reduce taxes now. But recognize that a change in economic conditions may occur at an early time.

I don't know when. Maybe next year or the year after that. Therefore it is important that a tax-reduction program be ready, perhaps even hearings held by the legislative committees, so that Congress could act rather promptly.

But my advice to this subcommittee is first to evolve a set of principles. Second, advise the legislative committees that there should be advance preparation of a tax-reduction program without setting a specific time for its enactment.

And, third, advice on the present tentative, in all modesty, very tentative economic outlook emphasizing the possibility of change.

Mr. MILLS. Thank you very much, Dr. Colm.

Mr. Curtis of Missouri will inquire?

Mr. CURTIS. Mr. Chairman, I would like to go back to the very first question and not to the question itself, but rather to a certain premise that was assumed in that question, because I think that is the fundamental issue involved, or one of the basic issues.

That reference and I can't quote it exactly, was to the effect that we have found that we cannot balance the budget in periods of depression.

I raise the question whether that is true or is not true. And raise the further question: If the real issue is not whether government has to spend the money or whether or not methods could be employed to stimulate private enterprise to spend the money?

I have no question in my mind that our society must face up to the problems that are created, but there are many ways that that might be done. And it is a question of how our political government, which after all, is just one phase of our society—how our political government can be best employed to solve these problems.

I don't think this is academic by any manner or means because we get into specific issues.

For instance, the development of public power was based on the assumption that private power companies were not doing the job. And I presume, assumedly, that they could not be stimulated to do the job. Even in things like social security, when we analyze it we are

talking about retirement for our people and, of course, private enterprise has been in that field through insurance companies and other savings devices for some time.

We could go on down the line of course, public housing, and so forth. We would see that this philosophy is definitely in the thinking of this present administration when they talk about standby public works programs. But the question I am posing is this: Isn't it true that as we attempt to solve the problem through the direct Government spending programs, political government, that thereby it means we have to increase our tax take, and at the very time we are trying to increase our tax take we are narrowing the base, because every time the Government moves into a particular function, an operation, whether it be the Federal barge lines or what, that particular activity, except for the salaries and wages of the people, is withdrawn from the tax base.

So pretty soon we get involved in a sort of spiral, where the tax base having been narrowed, the rate of course has to be increased on that which remains in the base to get the needed high take.

But the question I am posing: Isn't the basic issue right there in the very beginning, in talking about whether we have to balance the budget in periods of depression, based upon this question of whether Government has to do these things directly or whether there are other means whereby a political government can simulate the same thing?

And our limitations are those of economic realities, as to what a political government might be able to do in a field other than taxation.

You see I am harking back to what I said in my original statement.

Using the taxing powers to produce specific economic results and to operate as an endorsing power behind the government regulations seems implanted in modern political thinking.

I said I wonder if it would not be well to reexamine this political philosophy.

Now I would like to ask for any comments on that very general statement that I have made.

Mr. KEEZER. Well, Mr. Curtis, as I interpret the question it is partly why do we need to get into this trouble in the first place?

Mr. CURTIS. Yes, I am raising the question.

Isn't that one of the things that lies at the base of our whole discussion of the economic effects of taxation? Because we have moved in and we have to increase our tax take.

And at the same time we move in to take our tax take, we are narrowing our tax base.

Mr. KEEZER. Limiting my part of an attempt in an answer to a field which I specifically tried to cover, business investment, which I think everybody here agrees is the key element in both stability and growth, you now have a situation where the business community, given the funds, is going ahead.

And my emphasis is on seeing that that situation is perpetuated rather than waiting until the thing falls apart and then, having fallen apart, wondering what we should do about it.

I take it that if we predicate another 1932 there is nobody here who doubts that it would be necessary, with the peoples' confidence shattered, with their incomes considerably shattered, for the Government to act and act quickly.

My own emphasis is not on trying to pump it up again but trying to attain a degree of stabilization at a high level which we are now doing.

Mr. CURTIS. Now, you are addressing yourself to the point I am raising.

You say everyone agrees that the Government must act. And the whole question is how must it act?

Mr. Mills' question presumed that Government must act through direct expenditures of moneys. In other words, having an unbalanced budget in periods of depression.

I am raising this: Is that something that we can assume, that we have found out we cannot balance the budget in periods of depression?

It seems to me that is one of the basic issues in our discussion and we ought to start from that instead of presuming it.

In fact I found in the various papers that the premise has not been disputed. It was passed over in the very first, almost, sentences of this hearing.

Mr. KEEZER. Well, there are better economic historians here than I am. But it is my impression that the attempts of the Federal Government to balance its budget in the early years of the depression of the thirties had very unfortunate effects on the economy as a whole.

So that I would say that if we got in a comparable situation an attempt to balance the budget at the depth of the depression would be disastrous.

Mr. CURTIS. Don't you think it would be of value to look around to see whether there are other means that might be used instead of the direct expenditure of money?

In other words, don't you think that the economists of this country ought to examine instead of presuming that direct Government spending is the only way of doing it?

That is what is disturbing me. You may be right.

Mr. KEEZER. I tend to dismiss this whole lugubrious line of reflection because we are all more or less assuming another depression.

I think my takeoff is in another direction, attempting to stabilize and perpetuate at this level which I don't think is at all impossible.

Mr. HANSEN. Mr. Congressman, I believe you are raising a very large question of what should be the role of government in the economy?

Mr. CURTIS. That is part of it. But I am really directing it to this specific question as it relates to this question.

It seems to me that it is those political aspects, those political decisions, which have created the situation that we are involved in here right now in discussing how our tax structure is affecting our other economic endeavors.

Just as I say when you have a period of high tax rate, any time that the Government gives a concession on that rate it can direct the economic endeavors with considerable force.

And what I am posing is this: Don't we have to almost go back to the beginning, instead of presuming this question of whether the Federal Government has to have this big tax take, which it must have if it is going to go into these fields directly?

Because it is the big tax take that creates, I am suggesting that is where a lot of our problems occur. I think the discussion here indicates it.

I am just objecting to assuming something that is so basic without discussing it.

Mr. HANSEN. I think first it might be worthwhile pointing out that back in the days of the twenties, let us say, we had so small a Federal budget that we could accomplish practically nothing so far as anti-depression policy is concerned, by any drastic tax reduction because the thing was so small in the terms of the whole economy. And we at least have this one advantage of a large Federal budget, presumably for reasons that are necessary—we have this one advantage of a large Federal budget that in the event of a depression you can accomplish a tremendous lot by tax reduction.

That was not available in the twenties because the whole thing was so small it couldn't affect the economy much.

Mr. CURTIS. All you are saying is because the Government has moved into the field of economics to the extent it has, that therefore what the Government does becomes pretty vital in our economics.

Mr. HANSEN. I will then come to that question. I think there the fundamental question is to decide what should be the role of the Government, what should be the volume of Federal expenditures. Now, most of our current large budget is for defense. The cold war forced us into it.

In other areas, then, it is a question, again, I agree with Mr. Hagen entirely: The first consideration is what should be the volume of Federal expenditures, not for purposes of curing depression, but only on their own merit?

And that then involves the question of how can the things that we desire to have done be accomplished?

Can they be accomplished without Federal activities?

School is a case in point. You mentioned public power. In my view in large areas of this country private investment can be enormously stimulated by public power.

Mr. CURTIS. I was just suggesting those to illustrate the point I was driving at that each time in each area of course we increase the Federal budget, if we decide to go into it direct, and at the same time, we narrow the tax base, which—I might say this possibly to clarify what I am getting at. I don't know whether the chicken comes before the egg in this thing.

But I feel quite deeply that once Government embarks upon a program of a big tax take, then it finds it has this tremendous power of granting tax concessions. It can use the taxing power to produce economic effects instead of using the direct and more traditional methods, in this country at any rate, of producing those economic effects. And I am beginning to wonder whether we, and I am thinking this as a member of the joint committee as well as the Ways and Means Committee, whether we aren't using the taxing power even more for producing certain desired—we think, certain economic effects—instead of to get revenue. I think we are right in the middle of that.

Mr. HANSEN. I agree that that is the case, and I personally welcome that because I think we can produce very desirable economic effects through the fact that the Federal budget is large. I wouldn't want to make the Federal budget large unless it was desirable to have it large, judged on its own merits. Then, having desired what is a desirable budget in terms of defense, in terms of schools, other non-

military expenditures, having decided what it should be, then it becomes a question of how high should the tax rates be and what should be the appropriate tax structure.

Mr. CURTIS. But you have no objection in—you see no economic dangers in using this tax power granting concessions, certificates of necessity, which is a typical example, whereby granting a tax exemption you can produce a specific economic endeavor.

Now, that technique, that use of the Government power, you see no basic wrong in it? I don't mean the word "wrong." You see nothing that is disturbing.

Mr. HANSEN. No; I see nothing disturbing about it. We might pursue—having that power we might pursue wrong policies which we have to debate and discuss and change if we find they are wrong.

But I see nothing disturbing in the fact that a large Federal budget does give us the power to influence the economy in various ways. That I would welcome very much. In fact, without that I would feel very much alarmed about the future of the American economy, without that stabilizing power of the Federal budget.

Mr. CURTIS. In other words, for that reason, then you might tend not to want to get back and move Government out of certain areas of business, for example, which helps to keep it.

Mr. HANSEN. I would judge that on its own merits, because I don't think that policy depends primarily upon the size of the Federal budget, though there is the point I made before that if it is so small that it doesn't amount to much in the whole economy, then its power is limited. But I would certainly not decide this matter on the ground that well, we need a certain size budget in order to accomplish these ends, because I don't think that is the case.

We can adjust tax policy to various levels of the Federal budget quantitatively considered. We can adjust tax policy to accomplish the ends that we wish. The budget is large enough so that there could be a very wide range in the size of the budget and still we would have ample room to move around and to influence the economy.

I would not determine the size of the budget on the ground that, well, we need a certain big budget in order to accomplish certain ends. I don't think that is so.

Mr. CURTIS. Will anyone else comment?

Mr. GEORGE. I was trying to find a starting point to the question that you were circulating.

Mr. Chairman, I thought maybe I found it in your chance use of the phrase, or perhaps yours, Mr. Curtis, that they are always telling us that we must do something about this cylical situation this year, and to what extent should adjustment in taxes be among the things we do? My reaction to that question at the moment is that you're off the hook for once.

I made clear awhile ago that I don't place any great store by my forecasts and wouldn't want the country to be administered by any rigorous conformance to them. And I am so ungracious as to extend those doubts to most of my brethren in the same business or sport.

Nonetheless, I can't answer the question I posed above without one. In my judgment, we have got enough momentum right now that looks capable of carrying us well into the second quarter of 1956. Thereafter the odds strike me as favoring a small decline in dollar demand

if taxes are not cut. My own projection for the second half, reflecting belief that defense spending would run a bit above its third quarter 1955 annual rate, other Federal plus State and local GNP outlays would edge upward at the annual rate of $400 to $500 million per quarter and credit be eased moderately, is that such demand will be a few billions larger in that period, but this assumed that the Congress would reduce taxes by $3 billion to $3.5 billion.

The same level of activity could doubtless be obtained without tax reduction, but only through a quite radical reversal of credit policy or through further deliberate boosts in Government GNP spending or transfer payments. The projected rate of demand would be almost enough to keep us at full employment.

Policywise, the first thing to be said against this background, I believe, is that since at worst the slack to be absorbed would be so moderate and since so many things can happen between now and mid-1956, we would be well-advised to adopt a wait-and-see attitude for awhile. This is all the more true because the strength of built-in flexibility is great enough to enable us to proceed cautiously without risk of serious consequences. Admittedly, however, my projection, if valid, implies that by late spring next year it will be desirable to have either a tax cut of the order indicated, or perhaps even a little more, or very strong stimulating action in the monetary sphere and/or a fillip to Government outlays. Of these, I would prefer the second and third, assuming expenditures could be directed to really essential needs. One reason is that I'm not happy about the kind of tax cuts that are likely to made in an election year. But I have to admit that tax reductions might still be necessary since it seems rash to count upon monetary policy to do most of the job and since we will not yet be equipped to boost outlays judiciously save perhaps in defense. This generalization appears valid for all major fields of nondefense need—highways, schools, slum clearance, and urban redevelopment, to name some of the more important. So my basic preference runs against tax reduction, but would have to be qualified by any finding that selected expenditures couldn't be made to move fast enough. I think that the two avenues have to be explored jointly.

Mr. CURTIS. May I interrupt you just a minute there, because I think that illustrates a point. Urban renewal and slum clearance are a method of Federal Government mainly to get other people to spend money, rather than the Federal Government.

Mr. GEORGE. I am not against that.

Mr. CURTIS. I know that.

But I am trying to point out that would not add greatly to the Federal need for tax take, while public housing programing would. I don't want to interject this as an argument other than to comment that that happens to illustrate what I am driving at, whether we shouldn't on all these things—I am not an economist—but as economists and those of us who are in politics, get back to the very basic issue involved here which is the height of the tax take.

Maybe nothing can be done about it, maybe all these arguments are so, that we are in a period where we are going to continue. But I would hate to just assume it without making a thorough analysis of it, particularly in these studies that the joint committee has embarked upon.

Mr. GEORGE. Of course, in the urban development I was trying to think back. I think the Federal Government does contribute a substantial share but it does largely through making up two-thirds of the difference between what a locality spends to acquire and clear slums and plan this redevelopment and what it obtains for the land through sale or rent.

Mr. CURTIS. I think it is more of a guaranty if I am not mistaken.

Mr. GEORGE. I think it's an actual outlay.

But I quite agree with you that everything that possibly can be done should be done to have business accept its share of the responsibility for maintaining high activity at stable prices or reasonably stable prices. And there is an awful lot of work being done on that in recent years.

Mr. KEEZER. I think that point might have gotten slurred over. It seems to me that we would all accept the proposition that anything that a private establishment can do tolerably well is better done by that private establishment than by the Government.

Now, with that basic proposition—I didn't want to get confused on that basic proposition——

Mr. CURTIS. No; really it is a very difficult thing to try to keep this from becoming an issue of whether Government should do this or should not, because I am not trying to do that. I am simply posing the question that if Government does do it, then in a cumulative way we increase this tax take which I am suggesting is the problem.

And therefore, I think it becomes very important, if that is the thing that is behind our tax problem—and I am convinced it is as it affects our economics—I think we ougt to do lot of careful thinking on these things because the cumulative effect has been terrific. I have got some figures that I don't know—frankly, I have been trying to trace down their original source. But it does show private capital investment in relation to public capital investment.

In 1929 the ratio was 9 to 1; in 1952 the ratio has declined to 5 to 1. Essentially, our tax base is private capital. Now, those are the things that seem to me to be so basic that they deserve a lot of careful research and study. Even those ratios I gave—which come from the Tax Foundation's booklet Facts and Figures on Government Finance. I happen to have the 1952–53 edition. But they carry the same figures and don't bring them up to date, I regret to say, in their 1953–54 edition. It is chart No. 16 estimated national wealth on currency, in 1929 dollars.

But that is the overall problem I am trying to get out before this panel and also before our whole committee.

Mr. HAGEN. I would like to address myself to part of the original question you asked. I would really like to make two points. One is that it would be of interest to know: suppose the Government were completely out of business in the sense in which that phrase is usually used, how much would it reduce the total Federal expediture?

A very considerable part of the total as we all know is for defense. And if some of the public investment that now goes on for defense were private investment done for the Defense Department, it will have to be paid for by the Government anyway, so that this may not be as large a share of the total as it seems.

Mr. CURTIS. May I comment on this?

Having been on the subcommittee that was investigating military procurement, and supply in the 82d Congress, and trying to follow that thing through, the Federal Government through the military has moved tremendously into fields that traditionally were private enterprise.

We used coffee roasting; we used that as a specific test. But also paintmaking, ropemaking, tire retreading, and so forth.

So just because it has a uniform on it it is no reason an economist can't look behind it, and see whether that is really defense or whether it is an endeavor that can be performed in the private enterprise or performed within the tax base.

Mr. HAGEN. Yes. My point on this simply was if the Army or the Defense Department bought the coffee, paid for the coffee roasting, expenditures would not be reduced because it was done privately. It would be done, paid for in another place.

Mr. CURTIS. Then we get into a more basic problem. I would like to point out it gets into this question of which personnel system produces efficiency.

Mr. HAGEN. Yes.

Mr. CURTIS. I submit, and I hope most economists agree, that we only go to political government when we have no other recourse. That the better more efficient system is the private enterprise if there is real competition.

Mr. HAGEN. Yes. I didn't intend to get into the question of which is more efficient. The basic point I want to make is a different one. You asked, Is it necessarily true that the Government must have a large deficit if there is a serious depression? Isn't there anything we can do to get private instead of public spending in that case?

I would like to talk about that. Certainly, in prosperity we should make every effort to maintain the level of spending. As Mr. Keezer has said, keep us up here, and not get into trouble. However, as he also noted, a very important factor in the economy, both in stability and growth, is business investment, to which I might add housing construction. Now, a business concern builds new plant and equipment for one of a couple of main reason, either to increase its capacity when the plant is growing, or else to introduce new methods and products in place of old ones. Turning to housing: houses are built because families want more accommodations.

There is no reason to suppose that the amount of investment and housing for those reasons will continue year after year, and decade after decade, at the level needed to maintain full employment. They are done for a different reason. The corporation doesn't invest in its plant because the country says it needs it for full employment. It can't do that in fairness to its stockholders. It does it to increase its capacity or to introduce new products and methods.

Now, let us suppose—and there is every reason to think that sometime or other this may be true—let us suppose the level of housing activity and investment done for these legitimate reasons falls off a good deal because business concerns do not need as much new construction, and because we are "housed up," so that fewer new housing units per year are needed.

If this occurs, we might have a serious depression which is nobody's fault, which is because we didn't happen to be lucky. I think we can

expect to be lucky most of the time, but I don't see that we can expect to have enough investment and housing construction for ever and ever without a dip.

I think in that case—if we had a serious depression because housing construction and business investment fell off materially—then almost certainly there is no feasible way in which sufficient private spending could be induced by Government action. It would be necessary to have a Government deficit. That deficit need not be incurred by increasing expenditures. I think public works in that case would almost certainly be desired. But the deficit might be acquired because tax revenues fell and tax rates were cut. But if a serious depression occurs at some time for the reasons I sketched—I see no reason to expect it in the near future—there probably is no feasible way of inducing enough private spending to avoid a deficit.

There will have to be a Government program.

Mr. CURTIS. Thank you.

Mr. COLM. Mr. Curtis, I would like to make a few comments on the question you raised which I thought is a very crucial question.

First, one of fact, I have not examined the figures which you mentioned but perhaps the following may shed some light on the problem. We are running now total investment excluding inventories, that means everything that we call fixed investment, at a level somewhere between \$50 and \$60 billion per year, closer to 60 than 50.

Now, in the budget for 1956 we have fixed investments included of \$1½ billion. So the relationship between the Federal investment in fixed assets and private investment is 1.5 to almost 60.

Mr. CURTIS. That is new money going in?

Mr. COLM. New money going into the Government assets, Federal Government assets. Of those, more than one-third goes into the atomic energy establishments' fixed assets. So I would say that excluding atomic energy where we have a special reason why the Government invests in that field, there is a very small percentage of total investments in our national economy which is directly financed by the Federal Government.

Mr. KEEZER. Would that include investment by the Military Establishment?

Mr. COLM. Yes——

Mr. CURTIS. That figure is awful low. We are spending military at a rate—what is it? Around 30 billion. Of course, a lot of that is salaries and services.

But I question whether it is a small figure as 1.5.

Mr. COLM. I said too quickly "yes" in response to Mr. Keezer's question. The figure used does not include the military investments. The stockpile is extra. Also barracks and battleships are not included in that figure.

The figures come straight out of the budget document. This was just a comment on the facts. Of course, during the period of the Second World War, we had the Defense Plant Corporation which built a large number of plants. Then in the rearmament after the invasion of Korea we used another method where the Government did not build the plants, but to a large extent used the accelerated depreciation device for getting private industry into it. But on the question of whether we want to stimulate the economy through private opera-

tions, I think we all agree here, I heard it from various of my colleagues, that as distinct from the period of the thirties, an economic stabilization policy can rely to a much greater extent on tax reduction rather than on increases in expenditures, for the simple reason that the tax bill is so much higher and one advantage of a high tax bill is that you can reduce it.

During the thirties when the whole tax take was small there wasn't much tax to reduce and you could only go up with your expenditures.

Furthermore, there is such a backlog in needed expenditures—I am referring to those figures, which show a tremendous lag, because of the Second World War, postwar inflation, post-Korean rearmament, and so forth—that I think some increase is necessary on its own merits. And the only thing you can do is to time the increase in such a way that it gives you support. But there is nothing that automatically gives you the right amount of support just when support is needed. Nor do I think any economist would propose a leaf-raking proposition, to increase expenditures for expenditure's sake.

Now, Mr. Curtis asked the question whether we couldn't do quite a bit also by the indirect means, such as the housing program, through guaranties and insurance.

I think much of that can be done. In the case of housing this method has made a considerable contribution to the stimulation of private activities. However, taking the road construction bill as another example, I would feel very uneasy if the proposition is made to finance such a program outside of the budget simply to keep the expenditures down and to balance the budget.

I think there we would be fooling ourselves. I think whether these expenditures are included in the budget or outside of the budget is immaterial from the economic viewpoint. I don't think that we should force things outside the budget simply in order to keep the budget small.

Mr. CURTIS. Thank you, sir, I appreciate that.

Mr. MILLS. Did you desire, Mr. Woodward, to comment?

Mr. WOODWARD. On that same point, yes. I will make it brief, Mr. Chairman. I wanted to respond to Mr. Curtis' question of whether we had to assume an unbalanced budget or a deficit in a depression. And I responded that I am afraid we must assume such a thing. I think I say it with more reluctance than some of my colleagues. But I do say it, as I am compelled to the conclusion. But I don't think we should stop right there, because there remains the question: Are we trying to limit that budget, and how hard are we trying, and are we putting our ingenuity to it?

It seems to me that a number of things have been mentioned in this discussion that have been done or can be done and it seems to me that if we put our ingenuity to it, probably more can be done.

All the bright ideas haven't yet been born, there can still be more if we try for them, to lessen the extent of that budget. It seems to me it is desirable to lessen it for reasons that have been alluded to.

I was a little unclear on Mr. Hagen's earlier point that the built-in stabilizers do not work in the direction of turning recession around into recovery.

It seems to me they do and I know we are pressed for time but perhaps that could be discussed more at a later session in your considera-

tions. Because I would be sorry to see the record leave that point standing unchallenged.

Finally, the term has been used 2 or 3 times here in the last few minutes that expenditures ought to be judged strictly on their merits.

I am a little confused as to what that means. If that means are we in favor of better housing or not, then it is a question like: Have you stopped beating your wife?

Of course we are in favor of better housing and it can become perfectly easy to argue that strictly on its merits, under certain considerations, if there is not appropriate housing at a certain location in a certain city, the only sure way to get housing built there at once is for Government to build it.

Therefore, it can be argued strictly on the merits of the case the Government has to spend the money. If that is what the term means, or if the term has meaning in that context, I would like to raise a question about leaving that interpretation of strictly on its merits unchallenged.

Mr. MILLS. Senator Goldwater?

Senator GOLDWATER. I have no particular question but I do have a comment or two to make.

It has been rather a sad experience this morning to sit in at the funeral of an old friend of mine, an old and tried friend of the economic system, namely, a balanced budget.

It has grieved me somewhat to see the ease with which legislators and economists can accept the idea that the balanced budget concept is dead.

I have not been convinced of that yet. I am one of those old fashioned people who cling to the idea that the Federal Government should and could balance the budget without any harm to the programs it has undertaken, without any harm, in fact I think with some decided benefit I think to the economy.

I was glad to hear this gentleman, the first gentleman who spoke, mention the disastrous effect of the attempts of the Government to restore the Government in the 1930's. Because I made a study into that and found in 7 years we spent over 50 percent of our total Federal budget in direct props or aids to our economy and to the people and we are all perfectly aware of the fact that they did not produce any results and it took war to actually bring us out of the depression of 1929.

Now I would like to leave this in your minds because it has been in my mind.

We have been talking about a deficit in a period of depression. I agree with you, I don't think we can escape deficits in a period of depression. Why not build up surpluses, in periods of prosperity?

And then when we have periods of depression we have excess millions and billions of dollars to divert into the economic streams of the country to maintain employment, to bolster the economy to the extent that it will resume its normal functions.

Now I have not heard that discussed this morning.

I don't quite agree with the idea that we should continue deficit spending through a period of prosperity, because what happens if we go into a depression—and Lord knows we hope we don't—where

do we get this money, the billions and billions of dollars that will be needed to bolster the economy?

Now in 7 years, in the 1920's we spent $26 million. That was a very small amount in these direct aids. But if the same proportion were to be used we would have to suddenly raise amounts upwards of $80 million to sustain and bolster the economy in any period of serious depression.

So we go on printing the money, we go into a period of depression, in a period that we can't even entertain the thought and I am afraid we wind up with a defunct Government.

If we go into a period of depression with an unstable and unhealthy fiscal situation in the Federal budget, that is all I wanted to bring in here. If anyone wants to comment I would be very happy to listen.

Mr. KEEZER. Mr. Chairman, shouldn't this funeral as Senator Goldwater called it, be a little less depressing?

I have not joined in an agreement that there is no object in balancing the Federal budget.

I have taken the position that over a considerable length of time it should be balanced. I have agreed with my colleagues that a year-to-year balance is something that is beyond the immediate realm of feasibility, and given a decline in business activity under certain circumstances, beyond the realm of desirability.

But I don't think, Senator, we have entirely created a corpse out of a balanced budget. It is a matter of timing which we are concerned with here primarily.

Senator GOLDWATER. Glad to hear the resurrection.

Mr. GEORGE. I think you are going to get the answer you want, having raised the problem so bluntly. I think what happens is we are fluttering around from aspect to aspect in these discussions without a clear decision on each one of them.

Now you may have noticed, I think several of us, at least, have not been in favor of cutting taxes this year, which would have been moving in the direction of what you want.

There may be different reasons among them, but at any rate that would be one of the products.

Senator GOLDWATER. Cutting taxes would not be in the direction of balancing the budget?

Mr. GEORGE. Not cutting taxes.

Senator GOLDWATER. Oh, I am inclined to agree with you.

Mr. GEORGE. What I am suggesting is that there may be considerable agreement on that point around the table, which ones again, would be a step short of the final interment of the body.

The real question, I think over the long pull comes to this, as Dr. Keezer stressed once again because it has been mentioned before, it is the slavery to a fixed period of time that gets us into this confusion.

One year, that has very little significance to an economist. It may be indispensable to an accountant. But we are more concerned about cycles.

And although I don't think as a practical matter we are going to balance the budget over time, that the cost in deficits is not going to be as high as it has been in the past 15 years on the average.

I am tolerating something that I don't particularly relish in accepting the need for deficits in a period of really serious depression.

However, it is a mistake to try to lump Government and citizens in a single category with identical risks and responsibilities. In a few respects, although they must not be abused, the Government is the ultimate depositary for all the stresses, strains, and impacts coursing through the business system. In that limited sense it is really the reciprocal of the private segments of the system and the two are engaged in an endless process of adjusting to each other. To make it a little more vivid, if the Government always balances its budget, a lot of businesses wouldn't.

Mr. WOODWARD. May I just say, sir, that I made what I thought was a fairly impassioned comment a while ago about the desirability of paying off some public debt. That would require a balanced budget during a certain part of the cycle.

I would be glad to make that impassioned plea again.

Mr. HANSEN. I think that one of the very important built-in stabilizers that we have at the present time, and I believe Mr. Woodward would agree with it because I have read some things he has said on this, is exactly the widespread holding of the public debt by banks and others.

I think we need to bear that in mind. That is one of our very important built-in stabilizers at the present time. I don't agree that the public debt is just an evil.

Mr. COLM. May I make one comment on Senator Goldwater's question?

I think here has crystallized quite a bit of common ground among the six economists with differences departing from that common ground.

I don't need to repeat that. I do emphasize that I recommended against tax reduction at the present time because I thought that a surplus in the consolidated cash budget for the next fiscal year appears desirable as the economic outlook appears to me now.

But what I would like to add to what has been said is that we should look at the national debt not merely from the point of view of whether it is now 275 billion or it is going up to 278 billion; I think a very important consideration is the relation of the payment of interest on the debt to some measure of national income or gross national product, whatever measure you choose.

It happens that the percentage, which we may call the measurement of the debt burden, is almost exactly the same now that it was before the giant borrowing during World War II began.

I think the relationship between national debt, the total level of activity of the economy, and the rate of interest is a very important aspect in addition to the absolute amount.

Therefore I do say that when we are talking here about a fiscal policy designed to support steady and balanced economic growth, we are at the same time—if we solve that problem—also making the greatest contribution to an alleviation of the burden of the public debt.

Mr. MILLS. Senator Goldwater, have you completed your questioning?

Senator GOLDWATER. Thank you gentlemen very much.

Mr. MILLS. Are there other questions?

Mr. KEEZER. Mr. Chairman, perhaps you said so at the outset, but if not, shouldn't the record show that we are making these large judgments as individuals.

Mr. MILLS. Absolutely, the record should clearly indicate that you are appearing here as individuals, in a desire to be of assistance to a subcommittee faced with a very serious problem. We appreciate more than I can express the cooperation of the panel.

I want you each to know that in the opinion of the Chair, and I am sure I am joined by other members of the subcommittee, that you have been most helpful to the subcommittee today.

We thank you.

The subcommittee will stand adjourned until 10 o'clock tomorrow in this chamber.

(Whereupon, at 12:50 p. m., the hearing was adjourned, to reconvene at 10 a. m., Tuesday, December 6, 1955.)

FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

TUESDAY, DECEMBER 6, 1955

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON TAX POLICY OF THE
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The subcommittee met at 10 a. m., the Honorable Wilbur D. Mills (chairman of the subcommittee) presiding.

Present: Senators Paul H. Douglas and Barry Goldwater, and Representative Thomas B. Curtis. Also present Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The subcommittee will come to order, please.

Today's session of the Subcommittee on Tax Policy will be devoted to discussion of the impact of Federal taxation on the distribution of real income and levels of consumption. As was announced yesterday, our procedure is to hear from the panelists in the order in which their papers appear in the compendium, Federal Tax Policy for Economic Growth and Stability. At the start of each of these sessions panelists will be given 5 minutes to summarize their papers.

We will hear from all panelists without interruption. The 5-minute rule will be adhered to and I have asked the staff to raise a card when the speaker has spoken for 5 minutes. Upon completion of the opening statements the subcommittee will question the panelists for the balance of the session.

I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee's questions.

Our first panelist this morning is Prof. G. L. Bach, dean, Graduate School of Industrial Administration of the Carnegie Institute of Technology.

Mr. BACH. My statement this morning is primarily aimed at filling in some background for your consideration of the testimony of other witnesses. It deals particularly with the question of how important it is to avoid inflation in the formation of tax policy.

I should like to begin by asking the question, if moderate inflationary pressures exist, what repressive tax measures are justified to offset these pressures?

When nearly full employment has been reached, should continued pressure for higher employment—say through a Government deficit—be applied even at the cost of moderate inflationary results?

To know what tax burden is worth incurring as a check to moderate inflation, it is essential to understand the effects of such inflation. To

provide such information, I studied the American inflation since 1939, and especially in the period of relatively full employment since 1946. My major conclusions are these:

1. There is little evidence that the postwar moderate inflations have had the alarming deleterious results sometimes forecast for inflation. The total output of the American economy apparently has not been reduced, through weakening faith in the value of the dollar, impairing the incentive to work, or other of the often claimed channels.

On the other hand, neither is there substantial evidence that these inflations have significantly stimulated total real output, though the evidence here is less clear than in the former case.

2. The impact of relatively mild inflation in redistributing current income among major economic groups is apparently less than is often claimed. Moreover, the redistributional effects which have occurred do not correspond closely to several commonly held beliefs about inflation. For example, during the postwar inflations the share of wages and salaries in the national income rose significantly, rather than being eroded by inflation.

The share of unincorporated businesses—both farm and nonfarm—fell substantially, unlike the usual claim that businesses are major inflation-period gainers, while the share of corporate profits and dividends remained substantially unchanged. (See table 1, p. 76, of the paper submitted to the committee.)

Neither is there much evidence that the recent inflation has significantly changed the size distribution of income.

Within these major economic groups, however, the differential effects of inflation were great. Persons and institutions on annuities and other fixed-income arrangements suffered drastic relative and absolute losses in inflation. Notable examples are older persons on annuities and pensions, whose incomes are relatively fixed, compared to the active groups in society whose incomes rose with rising prices.

3. Inflation's effect in redistributing control over wealth has been substantial. Between 1939 and 1952, roughly $500 billion (1952) prices of purchasing power of creditors was wiped out by inflation.

For the most part, these creditors were households. Table 2 on page 79 of the papers indicates the major creditor and debtor groups in the American economy. Table 3 on page 80 gives a more detailed picture of the position of different types of households. All groups were in debt to some extent, but the monetary assets of most (that is, assets payable to them in fixed dollar terms) far exceeded the debts they owed to others. The most extreme net creditors—those most vulnerable to inflation—are retired persons and older families, especially those over 55; and well-to-do families with net worth over $25,000. Only very poor families were significant net debtors.

The main net debtor in the American economy is the Federal Government. To some extent, taxpayers gain as Government bondholders lose from inflation, since taxes to pay interest and principal involve giving up less purchasing power. But insofar as the Federal debt is continuously refunded, rather than being paid off, the net gainers from inflation are the public as a whole. Inflation reduces the buying power of bondholders; it thereby increases the share of the Nation's real output and assets available to the buying public as a whole as its income rises with inflation.

The redistributional effects of inflation on wealth, therefore, are complex. They do not involve a simple shifting of purchasing power from poor to rich, from wage earners to profit takers, or any other such mass transfer. Rather, they involve a major burden on those scattered groups and individuals who are heavy net creditors relative to their general spending power—especially older families and retired persons.

In summary, this evidence suggests neither a state of alarm toward the effects of moderate inflation nor ready acceptance of these effects unless clearer gains appear likely than have been evident in the past. But it is essential to recognize that this analysis deals only with the effects of moderate inflation. It does not consider the crucial problem of whether moderate inflation could for long be kept from becoming rapid, more highly disruptive, inflation.

Mr. MILLS. The subcommittee regrets that it is not possible for Mr. Peter Henle and Mr. D. Gale Johnson to be present to participate this morning. It has been impossible for them to attend.

The next panelist is Mr. Richard Musgrave, professor of economics, University of Michigan.

Mr. MUSGRAVE. My paper discusses the distribution of the tax burden between spending units in various income brackets as well as provides some estimates of the consumption impact of various types of taxes.

Estimates of tax incidence are a speculative matter, but they are essential to intelligent tax planning. Not only is the distribution of the tax bill itself a major concern of tax policy, but knowledge thereof is also a stepping stone toward determining the impact of taxation upon consumption and investment.

My estimates of tax distribution for 1954 show an overall tax structure (including all levels of government) which up to, say the $10,000 income level, is considerably less progressive than is frequently assumed. This covers an income range which includes some 95 percent of spending units. Thus, spending units in the $2,000 to $3,000 bracket pay an estimated 28 percent of their income in taxes, as against 33 percent in the $7,500 to $10,000 range.

I may add that these are the results shown in line 17 of table 2 of my submitted paper. As I indicated in the paper, you may use somewhat different concepts and then get somewhat different results as shown in line 18 of that table, and in lines 17 and 18 of table 3.

Taken by itself, the Federal tax structure is more distinctly progressive, while the State and local structure is regressive. Looking at specific taxes, the personal income tax provides the major element of progression not only as between middle and high but also as between low and middle income brackets.

I think this is an extremely important characteristic of the personal income tax, this fact that it provides for progression between the lower and middle income brackets.

The estimated distribution of the corporation tax is more or less proportional up to the $10,000-income range. The property tax is estimated to be slightly regressive, while sales taxes and most excises are highly regressive.

It has been argued during the last two decades that the consumption impact of the tax structure will be the lighter the more progressive

it is. This relationship is correct in direction, but its quantitative significance is less than might be expected. The consumption impact of exercises will be considerably greater than that of income taxes if consumers disregard price level changes, but the difference will only be moderate if consumers plan on the basis of real income. The consumption impact of the corporation tax, to the extent that it is absorbed in retained earnings, is considerably less than that of personal income or excise taxes.

The consumption impact of any one tax, it should be noted, is not necessarily the same thing as its total deflationary impact. Under conditions of severe depression, it may be argued that only taxes falling on consumption have a deflationary effect; but this is not the case in a buoyant economy where taxes may go to reduce capital formation as well as consumption. The proposition that taxes which fall on consumption are bad taxes thus holds for conditions of depression only, and even then with some qualifiation.

In the buoyant economy, taxes which are highly deflationary are not necessarily bad taxes; indeed, a high degree of deflationary effectiveness may be an advantage rather than a disadvantage.

But deflationary effectiveness can be had in taxes which curtail capital formation no less than in taxes which curtail consumption, so that the choice between the two must be made on other grounds, including consideration of distribution and economic growth.

Mr. MILLS. Our next panelist is Mr. Theodore A. Andersen, of the Amos Tuck Graduate School of Business Administration, Dartmouth College.

Mr. ANDERSEN. I would like to address my remarks at what is ahead for consumer spending, how much will arise in 1956, and will the rise be adequate.

Over the next 12 months, the productive capacity of the economy will grow around $12 billion. That is, we will produce $12 billion more in goods and services a year from now without any general price rise.

Now, the question is will the demand for goods go up that much.

Well, we have some pretty good clues now about the outlook for certain types of spending in 1956. First of all, State and local government is likely to rise about $2 billion, construction spending and purchases of equipment by producers will probably rise about $3 billion, and so there we have accounted for about $5 of the $12 billion needed rise in total demand.

The rest of the increases in demand will have to come from consumers. In other words, we need a $7 billion rise in consumer spending over the next 12 months if we are going to keep our economy at generally full capacity.

Now, there are two factors affecting consumer spending. First of all, how much is their income going to go up and second, how much is their savings going to go up.

Based on the trend in wage and salary rates which are rising due to increased productivity, and due to greater spending in certain sectors of the economy, it appears as though disposable personal income will rise about $8 billion over the next 12 months. However, due to the loans which have been undertaken over the last 24 months, debt repayment will be rising at the rate of about $1 billion a quarter.

It has been rising at that rate over the last year, and will continue to rise.

This means that more of consumer income in 1956 will have to go for debt repayment, about $4 billion more. As a result the rise in consumer income of $8 billion will be offset by a rise in consumer debt repayment of $4 billion, making for a probable net rise in consumer spending of about $4 billion.

Adding up this increase in consumer spending with these other growths in demand it appears that the total demand for goods and services is going to rise about $9 billion over the next 12 months whereas the capacity to produce will be up at least $12 billion.

This means that we have a deficiency in demand that appears to be about $3 billion.

Since we want to keep the economy operating at full capacity, it would appear that at sometime in 1956, consumers will need a $3 billion tax reduction in order that their consumer spending move up in proportion to the growth in productive capacity.

Now, it is, of course, too far ahead to predict these growths of demand accurately. We can predict the growth in our capacity fairly accurately. We know what is happening to new plant and equipment, how much that is expanding, and so my suggestion would be that we wait as long as possible, let's say, another 4 or 5 months, until we see whether this weakness in the growth of consumer demand actually develops.

Consumer behavior cannot be predicted accurately. However, in October, the survey research center at the University of Michigan, completed a study on consumer intentions and attitudes.

It shows the consumers are generally optimistic. Consumers were not particularly worried about the level of debt, although their debt has grown.

However, the study did indicate fairly clearly that their plans to spend on durable goods will be down about $1 billion next year.

Now in 1955, all types of consumer spending were rising—services, nondurables and durables. In 1956, and this survey has been generally accurate since 1947, spending on durables will be down, spending on other types of goods probably up, giving us some increase in consumer spending, but very possibly not enough to keep pace with the growth in our productive capacity.

Currently, the demands on the economy certainly seem to be adequate to keep us at full employment for another 6 months. The backlog of orders, the shortage of inventories, construction contracts awarded, all indicate that we are going to be at or close to full employment for another 6 months.

However, we have some deflationary forces building up. Inventories are rising and once they get up to a high enough level that will be a deflationary force.

The other main deflationary force is consumer savings. Consumer savings will be rising at a fairly rapid rate due to these contracts which have already been entered into, and so I would guess that after 6 months, the growth in inventories and the growth of consumer saving would be strong enough to give us enough deflationary pressures that a $3 billion tax cut could be made which would not be inflationary, but which would prove of material assistance in getting this $12 billion rise in total business activity 12 months from now.

Mr. MILLS. The Chair on behalf of the subcommittee wishes to thank each of you for your appearance this morning, the information you have given this subcommittee in your compendium, and also in your statements, and we appreciate the contribution you have made to the thinking of the subcommittee.

This morning I will ask Senator Douglas to begin the interrogation.

Senator DOUGLAS. Mr. Bach, I notice that you speak of the period 1939–52, as being the inflationary period. Would it not be more accurate to speak of the period 1939 to March 1951. Didn't the inflation start in March of 1951?

Mr. BACH. That is quite correct; it did.

In the longer paper that I have prepared I tried to break the inflation down into 3 separate parts in effect: first the moderately rapid inflation of the actual war period, and then 2 bursts of inflation in the postwar period.

I did examine those separately. They have somewhat different characteristics. The inflation period of the war proper looked very much like the traditional economic textbook inflation period in terms of the impact on the distribution of income that we can see.

The two postwar inflation periods looked rather different, and had I had more time I would have spelled that out in more detail in the brief introductory comment I made.

Senator DOUGLAS. I noticed you used the Consumer Price Index as the measure of inflation. Would it not be better to use the average of the Consumer Price Index and the Wholesale Price Index?

Mr. BACH. I would defer to your judgment, as an economist on this. I thought that the Consumer Price Index was probably the one that most people were most interested in, and that is why I used it, not that it is necessarily a more significant general measure of prices in the economy.

Senator DOUGLAS. I was struck with your very careful and very thoroughgoing statement of the effect of inflation, which I think is a real contribution to thinking.

I take it what you are saying is that in your opinion mild inflation did not hold back output.

Mr. BACH. That is right.

Senator DOUGLAS. Also, that it did not really increase output. It was more or less neutral as far as output was concerned.

Mr. BACH. Apparently so in the postwar period.

Senator DOUGLAS. From the standpoint of equity, which should be not entirely ruled out of consideration: inflation means that creditors have a diminished, absolute income from the same amount of capital; isn't that true?

Mr. BACH. That is correct.

Senator DOUGLAS. Don't you think that that is important?

Mr. BACH. I do think that that is important, and I was interested in the problem, especially because I was trying to trace through just who those creditors were and just who it is who is hurt.

Senator DOUGLAS. It is bound to be important among the older groups, among the retired population, institutions, and those whose incomes are over $25,000; is that true?

Mr. BACH. I am not sure where I would put any particular person.

Senator DOUGLAS. I understand. Those are the groups?

Mr. BACH. Yes, sir. Those are the groups which seem to be hurt the worst.

Senator DOUGLAS. There is a doctrine afloat that a little inflation is not bad and also that a little inflation is good. Apparently, what you are saying is that a little inflation is not good, but that a little inflation is bad?

Mr. BACH. I would say personally a little inflation is definitely bad. My personal judgment on the evidence that I have found would be that inflation is well worth trying to avoid but I don't think it is such a seriously bad phenomena that it ought to become the dominant force in monetary and fiscal policymaking, nor do I think that the reason it is bad is the reason that is commonly, or very often given in discussions about inflation.

Senator DOUGLAS. Of course, the period of the twenties, for example, was a period of comparative price stability.

Mr. BACH. Yes.

Senator DOUGLAS. That is, in the years between the depression of 1920–21, and the sudden collapse in 1929, as I see it, the intervening period had been characterized by a fall in unit costs and a great increase in unit profits. In addition a part of the period was characterized by a failure of corporate profits to be reinvested so that, in a sense, they were sterilized; and a disparity between monetary purchasing power and the total of monetary prices developed. Is that true?

Mr. BACH. I think that is a generally accurate statement.

Senator DOUGLAS. So you are saying that stability of prices should not be the only criterion, but should it not be at least one standard to accompany an attempt to get normal increase in production of say, 3 or 4 percent per year, plus substantially full employment?

Mr. BACH. It is my judgment in this that it certainly should be a major goal.

Senator DOUGLAS. The policymakers should not be indifferent to an increase in the price level?

Mr. BACH. No; I think they should not and I might add at this point that I am in disagreement with Professor Hansen, who testified yesterday, at least in a statement made in his paper. I don't know what he said, because I haven't seen the transcript, but I might make this point clear: In the paper submitted to the subcommittee, on page 19, Professor Hansen states:

> It is, I believe, fair to say that under the protection of social-security payments, the problem of the impact of price changes on the fixed income group has become negligible.

That is in my judgment not correct. There is still a very drastic effect of inflation on the fixed income groups.

I have tried to point this out, particularly as to which fixed income groups are the ones that are hit the hardest by inflation.

Senator DOUGLAS. One of your very interesting statements was that wage earners apparently had not suffered during this period. Let us take the war period and then the postwar period. During the war period, is it not probably true that our real hourly wage rates decreased—real hourly wage rates?

Mr. BACH. Do you mean between, say, 1946 and 1952?

Senator DOUGLAS. No. The war period.

Mr. BACH. My impression is they were roughly stable, but I am not sure. I would have to check the facts.

Senator DOUGLAS. Weren't they compensated for by an increase in the number of hours worked, so that yearly income was maintained, or increased, but the power of an hour's work diminished?

Mr. BACH. Senator Douglas, I defer to your judgment. If you have checked your facts on that you are no doubt correct.

My impression was the contrary, that there was a slight increase in hourly, in real hourly earnings.

Senator DOUGLAS. That would be a very interesting study.

Does anyone else want to make a comment on that?

Mr. MUSGRAVE. I think the overtime factor would make a difference, whether we talk about straight hourly rates or whether we talk about a rate which would include substantial overtime.

Senator DOUGLAS. The real hourly rates, that is straight hourly rates, decreased?

Mr. MUSGRAVE. Yes.

Senator DOUGLAS. In the two postwar periods of inflation you said labor did not lose. How do you account for that? Was that due to increased and improved organization of labor, because in former periods, wage rates did not move up?

Mr. BACH. That is correct. There was a real change in the inflationary pattern of the two postwar inflations.

Senator DOUGLAS. How do you account for that?

Mr. BACH. I would account for it basically in two ways, I believe, although I am not an expert on labor organizations, and wouldn't want to pretend to be one: One is the general belief in the economy that it is extremely important to maintain general purchasing power, and the belief that wages represent a very large chunk of general purchasing power thus, although this is a rather tenuous point I think there has been public acceptance of the notion that the share of labor in the national income should be large and should stay large.

Senator DOUGLAS. That is with respect to business decisions.

Mr. BACH. I wouldn't put it quite as a decision. I would put it as a frame of mind, a frame of reference, which makes business more ready to live, to work, to operate in this kind of an environment.

The second force is a very real one. I thing that the unions have been pretty effective in the postwar period.

Senator DOUGLAS. Which would mean the unions have been a stabilizing force rather than an unsettling force in this respect.

Mr. BACH. If it is true that consumption is the supporting force in the postwar prosperities. I would put it a little differently if I may. It would mean that the existence of the unions and the existence of this changed attitude toward the labor share has made it possible in an inflationary period for the unions and the nonunion working group to not only maintain but to increase their share of the total product.

I wouldn't want to go on record as saying that I thought this was the thing that supported the prosperity.

Senator DOUGLAS. No. I understand.

Dr. Musgrave, I have been interested in your studies on this subject for a number of years. I take it that what you are now saying is

that up to yearly incomes of $10,000, taking into account State and local taxation, the rate of taxation is approximately uniform.

Mr. MUSGRAVE. Yes. I think that it is a fair interpretation.

Senator DOUGLAS. There are slight changes or differences among income groups but not appreciable ones.

Mr. MUSGRAVE. Yes. It seems to me that the major point in these data, if they are correct, is that over this very broad, middle income range, which includes, say, 90 percent of the people——

Senator DOUGLAS. Including the low-income range below $2,000.

Mr. MUSGRAVE. Including low incomes and everything but the top 10 percent or so, that this is essentially the case.

Senator DOUGLAS. How do you come to this?

The Federal income tax, which is frequently pointed to, is of course very progressive

Then there must be other regressive features in our tax structure. I wondered if you would isolate those.

Mr. MUSGRAVE. Yes. This result, of course, relates the overall tax structure of Federal, State, and local taxes.

Senator DOUGLAS. I wonder if you would point out the regressive features which offset the progressive features.

Mr. MUSGRAVE. As appears in looking at table 2, on page 98 of my paper, the personal income tax is the progressive element in the tax structure. The excise and sales taxes are the strongly regressive element.

Senator DOUGLAS. Excise taxes on tobacco and liquor?

Mr. MUSGRAVE. Yes, and of course at the State level the State sales taxes.

Senator DOUGLAS. Have you ever gone into the assessment of real property by local authorities?

Mr. MUSGRAVE. Yes. Our estimates for the property tax show that it is slightly regressive at the lower end of the scale and then about proportional.

It does not show up as being a part of the progressive items in the tax structure.

Senator DOUGLAS. Of course it is not intended to be progressive but it is intended to be proportional. I would urge you to make a more thorough study of that if you would because my own observation in a number of local taxing units is that workingmen's homes tend to be assessed at a much higher percentage of their real value than industrial and commercial properties and I would urge you to broaden the statistical base on that.

Mr. MUSGRAVE. I think this would accentuate the pattern which I get here.

Senator DOUGLAS. That is right. So on the overall picture what you are saying is that the degree of progression in the Federal income tax about offsets the regressive nature of other Federal taxes plus excises and State and local taxes and produces an approximately proportionate tax incidence for the incomes from zero to 10,000.

Mr. MUSGRAVE. That is correct.

Senator DOUGLAS. How does this differ from your earlier study, Dr. Musgrave, which I have read with great interest a number of times?

Mr. MUSGRAVE. I have prepared here, Senator Douglas, a table, which compares the result of this study for 1954 with the study for 1948 and if I may be permitted I would like to insert this in the record.

Mr. MILLS. Go right ahead, sir. You may insert it.

(The document is as follows:)

TABLE 1.—*Estimated effective rates of tax for 1948 and 1954* [1]

[Tax as percent of spending unit income brackets]

<table>
<tr><th rowspan="2"></th><th colspan="9">Spending unit income brackets</th></tr>
<tr><th>Under $1,000</th><th>$1,000–$2,000</th><th>Under $2,000</th><th>$2,000–$3,000</th><th>$3,000–$4,000</th><th>$4,000–$5,000</th><th>$5,000–$7,500</th><th>$7,500–$10,000</th><th>Over $10,000</th></tr>
<tr><td>Federal:</td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>1948</td><td>13.2</td><td>13.4</td><td>13.4</td><td>14.6</td><td>15.9</td><td>16.5</td><td>17.0</td><td colspan="2">30.9</td></tr>
<tr><td>1954</td><td>19.9</td><td>11.3</td><td>12.1</td><td>13.8</td><td>14.7</td><td>15.8</td><td>19.0</td><td>21.8</td><td>32.1</td></tr>
<tr><td>State and local:</td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>1948</td><td>12.6</td><td>7.7</td><td>8.7</td><td>7.2</td><td>7.2</td><td>7.1</td><td>6.8</td><td colspan="2">6.2</td></tr>
<tr><td>1954</td><td>15.0</td><td>9.8</td><td>11.2</td><td>10.4</td><td>9.8</td><td>9.8</td><td>9.1</td><td>8.8</td><td>7.7</td></tr>
<tr><td>All levels:</td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>1948</td><td>25.8</td><td>21.1</td><td>22.1</td><td>21.7</td><td>23.1</td><td>23.6</td><td>23.8</td><td colspan="2">37.1</td></tr>
<tr><td>1954</td><td>31.1</td><td>21.1</td><td>22.8</td><td>23.5</td><td>23.8</td><td>24.7</td><td>27.4</td><td>22.9</td><td>39.5</td></tr>
</table>

[1] Excludes social-insurance contributions and is based on adjusted money income concept. Ratios for 1948 based on R. A. Musgrave and L. Frane, Rejoinder to Dr. Tucker, National Tax Journal, March 1952, table 1, line 6, and table 5.

Senator DOUGLAS. I take it the early study indicated a somewhat U-shape tax incidence. It was higher for the very lowest bracket than for those from two to three thousand, then remained approximately proportional, and finally went up at the high income end of the scale.

What you are getting in your new study is not a U-shape but an inverse L or more accurately a plateau followed by a rise.

Mr. MUSGRAVE. This is due to the fact that in the study for 1954, I have taken spending units with incomes under $2,000 as 1 group, whereas in the study for 1948, I had broken down spending units under $2,000 into 2 groups, 1 under $1,000 and 1 from $1,000 to $2,000.

In the table which I just mentioned for submission in the record, I have broken down the 1954 study into the under $1,000 and $1,000 to $2,000 group and if I do this, I get essentially the same U-shape picture which I get in the 1948.

The question then, is, if I may say a word about this, why did I in the main paper not follow this procedure, but instead, keep the under $2,000 as 1 group?

I did this because in the earlier study, this U-shaped feature received a very great deal of emphasis in public comment, and I thought somewhat undue emphasis, as against the major finding of the stability of the rate over the whole scale—let's say up to $10,000.

I thought that it was the more important to avoid this now because the importance of the spending units under $2,000 in the total picture has of course continuously decreased as income shifted up.

For instance, when in the mid-thirties Colm and Tarasoff made the first studies of this sort——

Senator DOUGLAS. I don't intend to put you on the griddle in any sense, but I would not think a value judgment about the social desirability of results should affect your system classification.

Mr. MUSGRAVE. This is not the case. May I go on for a moment?

You see, when these 1935–36 studies were made, about one-half of the spending units were under $2,000. If you take the case for 1946, about one-third of all spending units were under $2,000. Now it is about one-quarter.

Senator DOUGLAS. We have had somewhat different testimony in the material brought out in our hearings on low-income families which were held about 2 weeks ago.

I am informed by the clerk of the committee, Mr. Lehman, that according to figures which were then brought out, and we had people working on this for an entire year, in 1946 there were 9½ million family units with incomes of less than $2,000 per year, and in 1954 there were also 9½ million family units with incomes less than $2,000 per year.

What happened during that time was an increase in the total number of family units in the Nation of approximately 5 million so that the 9½ million formed a smaller percentage in 1954 than in 1946, but not a smaller absolute number.

Mr. MUSGRAVE. I am talking in percentages. My reference is to percentages.

Senator DOUGLAS. But it still leaves the problem of 9.5 million family units with incomes under $2,000 per year who are heavily hit by State sales taxes and excise taxes on tobacco. I am not saying whether they were hit by excise taxes on liquor or not.

Mr. MUSGRAVE. My first point was that this under $2,000 group has decreased greatly in relative weight in the total scale, compared to prewar.

Senator DOUGLAS. It has decreased from just under one-third of about 35 million family units in 1946 to 9.5 million of 40 million in 1954. That is to a little over one-fifth now. That is true. But still it is an appreciable part of the community.

Mr. MUSGRAVE. That is right.

The second point is that the people, the spending units which are in the under $2,000 group, and in particular the spending units which are in the under $1,000 group, are somewhat unusual, if we take the overall picture of spending units.

Among the spending units in the zero to $1,000 group, 50 percent are over 65 years of age, whereas if you take all spending units in all income groups, only 14 percent are over 65 years of age.

Also if you take the spending units with incomes under $2,000, 45 percent are single, whereas if you take all spending units, only 13 percent are single.

Senator DOUGLAS. Thirteen?

Mr. MUSGRAVE. Yes; 13.

Also, among the spending units under $2,000, 15 percent of them are farm operators, whereas for all spending units, only 8 percent, so you do have in this lower group a large representation of aged and single people.

Senator DOUGLAS. We are now talking on the basis of an equivalent adult male. The picture then would not be as bad as it seems when you take so-called family units.

Mr. MUSGRAVE. Since the typical family units in the very low brackets is different, its tax burden calls for a somewhat different interpre-

tation. I may add a third point which from a purely statistical point of view, is bothersome in these lower income groups. In making our estimates of the impact of sales taxes and excise taxes, our analysis is based on the estimated relationship between consumption and income.

Now in all these data, spending units with incomes up to about $2,500 show heavy dissaving.

That is to say, consumption exceeds income and that is a result which leaves one a bit uncomfortable. I think the whole state of affairs as to the information which we have with regard to the spending patterns of these lower income groups is somewhat inadequate.

As I have said, I am glad to have these data included but they do pose somewhat different problems.

If I may, Mr. Chairman, I would like to add another table, which shows the breakdown from under $1,000 and $1,000 to $2,000 for all the other tables which were included in my paper.

Mr. Mills. Without objection the table will be included.

(The table referred to follows:)

Table 2.—*Break-down of spending unit income brackets*[1] *for 0–$1,000 and $1,000–$2,000*

	Table 1		Table 2		Table 3		Table A1		Table A2		Table A4	
	Under $1,000	$1,000–$2,000	Under $1,000	$1,000–$2,000	Under $1,000	$1,000–$2,000	Under $1,000	$1,000–$2,000	Under $1,000	$1,000–$2,000	Under $1,000	$1,000–$2,000
1	0.3	1.3	3.5	3.0	2.7	2.6	1.0	5.0	2,386	11,934	87	364
2	-------	-------	-------	-------	-------	-------	10.0	13.0	7	56	-------	-------
3	.7	2.6	4.9	3.5	3.8	3.1	.9	4.6	11	91	120	425
4	2.0	6.2	7.3	4.6	5.6	4.1	1.1	4.8	3	37	179	556
5	2.0	6.2	6.4	.3	.3	.2	2.0	6.2	56	98	11	35
6	1.2	5.6	3.8	3.6	2.9	3.2	1.5	5.4	2,463	12,216	93	437
7	.8	2.9	19.9	14.9	15.4	13.3	.1	.8	3	21	490	1,817
8	.7	2.5	16.1	11.3	12.5	10.1	.1	.7	144	519	397	1,380
9	-------	.2	-------	.02	-------	.01	.6	4.1	117	205	-------	2
10	-------	-------	-------	-------	-------	-------	.9	5.8	365	324	-------	-------
11	.7	2.6	.2	.2	.2	.1	.7	5.0	21	37	5	19
12	2.0	6.2	8.3	5.2	6.5	4.6	4.0	7.0	59	381	205	635
13	1.6	5.4	6.5	4.5	5.0	4.0	-------	-------	709	1,487	160	547
14	.6	4.1	.4	.5	.3	.5	-------	-------	3,172	13,703	9	64
15	1.6	5.3	15.4	10.4	11.9	9.2	-------	-------	-------	-------	379	1,267
16	1.6	5.4	15.0	9.8	11.7	8.8	-------	-------	-------	-------	370	1,203
17	1.0	3.6	35.3	25.2	27.4	22.5	-------	-------	-------	-------	869	3,084
18	1.0	3.3	31.1	21.1	24.2	18.8	-------	-------	-------	-------	767	2,583

[1] Table numbers refer to tables on pp. 95–98, 106–111 of Federal Tax Policy for Economic Stability, Joint Committee on the Economic Report, Nov. 9, 1955.

Senator Douglas. Will you include an explanatory statement for each of your supplementary statements?

Mr. Musgrave. I think they are self-explanatory.

Senator Douglas. If not, you can explain them.

Mr. Musgrave. Yes. They have footnotes which indicate where they belong.

Senator Douglas. Now, I should like to ask you to answer a question I had intended to ask yesterday but could not for I was called away to attend another meeting.

Perhaps it is an unfair question, but it is a very fundamental question. It is fundamental because it deals with the underlying assumption in a good deal of modern discussion, namely, that there is a disparity between forces of consumption, loosely defined, and forces of production, loosely defined, and that economic policy and business

decisions in the public and private sectors must work together to produce a balance.

Now when I studied economics over 40 years ago I was taught that this was impossible, and there were 2 sets of arguments which were brought out.

First, there is the argument which the French economist, Jean Baptiste Say framed largely in a period characterized by handicraft, in which he said that the production of goods in itself constituted demand for goods.

Then in the modern period, the so-called orthodox school of economists led by Alfred Marshal, ridiculed the theories of John A. Hobson.

Hobson was regarded as a heretic among economists because he said there could be such a thing as oversaving, and the reply of the orthodox to this, which is the second argument, was that the very act of saving involves spending; that everything saved was spent, and even though invested—I now introduce a term which was formerly thought to be identical with saving—and even though invested it created a demand for labor just as if it were spent on consumption goods.

In other words, whether spent upon consumption goods or upon production goods, there was no disparity between these forces of production and consumption, and by implication there could be no business depression. This was the then state of economic theory. But business depressions continued, and as in the case of the 1929 breakdown, the depression and disparities became more intense.

I wondered if we could get any statement as to what if anything is wrong with this early type of reasoning.

We have the two hypotheses, and you might comment on them, or comment on the original understanding.

(*a*) Is there a disparity between savings and investment which at times means savings exceed investment and thus leads to inflation and at other times investment being less than savings creates sterilized purchasing power;

(*b*) Are our prices not fully competitive, but instead monopolistic, quasi-monopolistic, sticky, administered, or what have you, so that we may get into a situation in which the sum total of price tags on goods exceeds the sum total of monetary purchasing power in the pockets of individuals or business?

I wonder if we could have a discussion on this point, which is fundamental though not immediately connected with proximate issues, but which in part determines whether there is any advantage in differentiating our tax treatment between productive forces and consumptive forces.

Mr. ANDERSEN. Well, to say that an increase in production probably will lead to an increase in income and spending is true but we must remember that credit is a much more important aspect in a modern economy than it was in the period in which that doctrine developed.

For instance, consumers will borrow over $35 billion this year. They have income after taxes of something like $270 billion, and then in addition they borrow another $35 billion.

That income of $270 billion was the result of production. Goods and services are produced and that generates income, but then over and above that income they go out and borrow, and so in a given period,

you may have demand running substantially ahead of production, because of this use of credit.

Senator DOUGLAS. You mean demand expressed in money terms?

Mr. ANDERSEN. Yes, in money terms. The surveys showed that the percentage of consumers that are willing to borrow is going up and up. Now something like only 10 or 15 percent of families have an aversion to borrowing, whereas I am sure 25 years ago most families would feel definitely against going out and borrowing and spending more than they are making, but now we have had a cultural change, due no doubt, to a growth in income, and so demand can run substantially ahead of production through the use of borrowing.

Senator DOUGLAS. You are speaking of monetary demand?

Mr. ANDERSEN. Yes, monetary demand can run well ahead of production.

Senator DOUGLAS. And the consequence of that?

Mr. ANDERSEN. Well, that occurred in 1955, of course, but we had some slack in the economic system to absorb it.

We had some unemployment, we had some idle resources and so when consumers began to borrow heavily in 1955, it did not result in appreciable inflation. We drew people into the labor force that previously had left; we had some new additions to labor force.

Senator DOUGLAS. The same is true of Government borrowing policy; is it not?

Mr. ANDERSEN. Yes.

Senator DOUGLAS. When we have substantially full employment, what then?

Mr. ANDERSEN. Then if you have full employment, prices begin to rise. These goods and services that are produced are allocated to the highest bidder. I have been with the automobile industry for the last 5 years. We know how it has worked.

The dealer adjusts his allowances on trade-ins and when demand is very great, he gives you less than the car is worth and only the highest bidders then can get new cars.

Senator DOUGLAS. Would you say that was actually done?

Mr. ANDERSEN. Oh, yes.

In other words, the cars are rationed to the highest bidder and the rationing process takes place through the allowance in the trade-in.

We had cases where on 1-year-old Cadillacs, the owner got an allowance of $50 for his 1-year-old Cadillac.

Well, he wanted a new Cadillac and they were scarce.

Senator DOUGLAS. And were there cases of new cars being sold above listed prices?

Mr. ANDERSEN. Yes, through the "pack" technique.

We had cases where customers were charged an extra several hundred dollars for the 8-cylinder engine. He did not know that was the regular engine and so he paid extra.

Consumers have a very excellent record for paying their debts, and they have borrowed this $35 billion, and I am very confident that they are going to repay it.

Now what this means is that more of their income in 1956 is going to have to go for debt repayment. It already is up about $4 billion.

Debt repayment a year ago was running $30 billion, now it is $34 billion and it is going up to $38 billion.

Consumer income will go up about $8 billion but half of this increase is going to have to go for higher debt repayment leaving only $4 billion growth in spending, and since I believe we will need a $7 billion rise in consumer spending I see a $3 billion deficiency, which I would like to see made up through a tax reduction, some time later on in the year.

Some people have suggested if we run into deficiency we will change the monetary policy, and make money easier to borrow.

I don't know if it is good to get out of the situation by encouraging them to borrow more.

Borrowing may be a one-shot deal. In the next period they have to pay it back. If in the next 5 months it develops the way the clues seem to indicate it will, if the forecast actually begins to materialize, I would rather see this deficiency made up through tax reduction. It would be modest, $3 billion, and it would not come for another 6 months.

You would still have a balanced budget. I think you would run a nice surplus even after $3 billion tax reduction.

Senator DOUGLAS. That would be the cash budget.

Mr. ANDERSEN. It depends on what happens to the next spending program, but I don't think it would be inflationary. I don't think it would necessitate a deficit, and I would rather see the consumer—

Senator DOUGLAS. You are still speaking of the consolidated cash budget and you included the excess of social security taxes over benefits.

Mr. ANDERSEN. Yes, Senator.

Senator DOUGLAS. There has been great objection to this cash budget in the past. It is interesting to see many who objected to it then welcome it now. I like to think that we should keep the administrative budget in mind, too.

Mr. ANDERSEN. If we get a growth in income of gross national product of $12 to $15 billion I think the administrative budget is also going to be in balance.

Senator DOUGLAS. But there won't be a surplus.

Mr. ANDERSEN. This is after the tax cut it will be in balance.

Senator DOUGLAS. You will have a $3-billion surplus.

Mr. ANDERSEN. Before the tax cut, I believe so.

Senator DOUGLAS. I take it you advocate this because you think that without it consumer durables are going to be in some trouble the latter part of the year.

Mr. ANDERSEN. I would not say trouble. I think they are going to be off. The industry is coming out with completely new cars next year, every car except Chevrolet and Pontiac will have a completely new body shell and the styling will be radically changed.

I think we will get a pretty good stimulus to durables in the fourth quarter.

Senator DOUGLAS. You are speaking of automobiles.

What about refrigerators, etc.?

Mr. ANDERSEN. The consumer attitudes show the people plan to spend more for appliances in 1956 than in 1955.

Senator DOUGLAS. The automobile styles will be changed?

Mr. ANDERSEN. Automobiles are the problem for the next 9 months. They have been eating high on the hog. We have had a tremendous year.

Senator DOUGLAS. Is that true of the dealers?

Mr. ANDERSEN. The dealers had a much better year in 1955 than in 1954.

Senator DOUGLAS. You mean when you are lying on the floor you can't fall out of bed?

Mr. ANDERSEN. If you get a 20-percent return on investment, overall I think it is better than other retailers.

Senator DOUGLAS. We have gotten from this general question into a specific discussion of consumer durables. I wonder if Dr. Musgrave or Dr. Bach would address themselves to this general question that I threw out, What if anything is wrong with the doctrine that everything that is saved is spent?

Mr. MUSGRAVE. As you indicated, between the lines of your question, there is no reason at all why Say's law should always hold.

In other words, as Mr. Andersen suggested, people may spend more than they receive.

There may be dissaving, or people may spend less than they receive. They may hold part of their income.

Senator DOUGLAS. That would be not only by individuals but it could be by financial institutions too.

Mr. MUSGRAVE. Yes, sir.

Senator DOUGLAS. That is, the disparity between savings and investment which Mr. Keynes wrote about in his General Theory of Employment, Interest and Money.

Do you think that is an adequate explanation of disparities between consuming power and productive powers, so-called?

Mr. MUSGRAVE. I would say it is a formula by which to approach explaining it, because the real question still remains, Why do consumers spend less than they receive or more than they receive, and why do businesses spend less or more?

Senator DOUGLAS. Do you think that is an adequate explanation? Would you stop there with the disparity between savings and investment?

Mr. MUSGRAVE. I would proceed to examine why it should arise.

Senator DOUGLAS. You would not want to go into another field of inquiry and say why are there other forces which cause Say's law and the Marshal refutation of Hobson.

Mr. MUSGRAVE. I would say this is as good an entry point as any for analyzing.

Senator DOUGLAS. Do you want to go any further?

Mr. MUSGRAVE. This is the best avenue to the problem I could think of.

Senator DOUGLAS. What about the question of sticky prices, monopolistic prices, and quasi-monopolistic prices? These do not give price decreases and thus increased real purchasing power. Thus, the failure to lower prices fails to give expanding consumer purchases. Therefore monetary purchasing power is insufficient, to come up to the level of the sum total of these "sticky" prices.

Mr. MUSGRAVE. It has been pointed out by quite a few people that if you had really wholly flexible prices, you could not have what in economic jargon is called unemployment equilibrium.

This can come about only if there are price rigidities but I don't see how realistically speaking in this world of ours, the answer to

hoarding, or excess of planned saving over investment can be found by introducing complete downward rigidity of prices.

I think in our——

Senator DOUGLAS. You mean downward flexibility?

Mr. MUSGRAVE. Downward flexibility of prices. I think that is not possible in our framework.

Senator DOUGLAS. If the failure to do so is the cause, and if it is impractical to have downward flexibility, then the alternative would seem to be to increase monetary consumer purchasing power to the quantity of the sum total of the price on goods.

Mr. MUSGRAVE. That is correct.

Senator DOUGLAS. This furnishes an argument for trade unionism, provided the wage rates and other measures to expand consumer purchasing power, are not carried too far; isn't that true?

Mr. MUSGRAVE. I would say as far as the wage-rate argument goes, that an increase in wage rates in this situation would help only to the extent that your wages are paid out of funds which otherwise would not have been invested, but would have been retained idle by corporations.

Senator DOUGLAS. The supply of bank credit is however not a fixed quantity. If wage increases lead to pressure by businesses upon banks to lend more we would get an increase in monetary purchasing power; would we not?

Mr. MUSGRAVE. If that were so, then that would be the result but I wonder whether this is a normal channel through which bank credit is generated.

Senator DOUGLAS. Mr. Bach, do you want to comment?

Mr. BACH. I would like to comment on our discussion of inflation. It seems to me here you have one of the major keys to the inflation problem in these questions you have been raising.

I should suspect that the main reason the price flexibility would not work, is not practical in Mr. Musgrave's terms, is that you simply could not keep the union people at all happy with actually stable dollar money wages, that a situation in which you have the possibility of gradually rising money wages, even though in real terms they get no more than if prices had been falling, is a very real consideration in our society, and one should not brush aside the importance of which of these——

Senator DOUGLAS. May I point out that prior to 1929 we had almost no unionization in the mass-production industries of the country, and that as I remember it, we had substantially stable money-wage rates from approximately 1923 on through 1929, though output per man-hour was rising. Therefore, the cost per unit of output was falling.

Mr. BACH. Yes; this caused the profit inflation which you described.

Senator DOUGLAS. It most certainly affected the stock market.

Mr. BACH. Yes; I am suggesting that a situation like that in which prices fell would have been a more stable situation, but that I doubt under modern circumstances that the laboring group in our society would be very happy about that.

There is a reason why they should not be.

Senator DOUGLAS. May I point out that even though we did not have unionism in this period of the twenties, still prices did not fall,

so it was not the insistence of labor on higher hourly rates which caused the breakdown, but it was instead the failure to reduce prices in the absence of unionism which helped to cause the breakdown.

Mr. BACH. I agree with your analysis but I am suggesting the world is different today than it was in the twenties.

Senator DOUGLAS. May there not be greater general stability produced by the very fact that labor is pushing for an increase in the hourly rates, which helps to build up monetary purchasing power at least to the level of the increase in output and, at times possibly, more.

Mr. BACH. This is the concern as to whether the upward push may not be more than can be tolerated within the price level.

Senator DOUGLAS. I would say that to the degree to which wage rates are increased to take account of the increase in production it is a stabilizing factor.

Mr. BACH. I will have to go back to Mr. Musgrave. It is a stabilizing factor if in fact some of the difference would have been saved and not reinvested by the corporations, which might well be the case or might not be the case.

Senator DOUGLAS. It would take a lot of time to discuss the 1929 period.

I don't know that one can conjecture, but as I see it in the period from at least 1927 to 1929, when we had a big-profit inflation, business was not reinvesting its profits at the same rate as before because it woke up to the fact if it did so it would have to turn out more goods. This further increase in production would have caused a fall in the price level and, therefore, to maintain price levels business chose to restrict investment, which resulted in a serilization of savings.

Mr. BACH. I can't peer into the motives of the men who did those things, but I think you are getting to a very important point and I would like to add to the points these other gentlemen have made.

Your question was basically, What difference does it make whether we stimulate consumption or investment?

Senator DOUGLAS. That is right.

Mr. BACH. I would like to suggest that in addition to the points that have been made there is a real factor involved, a bunching phenomenon. You will remember Mr. Robertson and Mr. Schumpeter made this point very strongly and so did others, that we don't know just what is the balance that can be maintained for very long between how much is spent on investment and how much on consumption.

This is a very hard thing to pin down precisely, but we do know pretty clearly that if you get an enormous bunching in one relative to the other, you get them out of balance too far, given the lack of competitive pricing that we have mentioned. This has been true in the case when you had a bunching of investment without a corresponding rise in consumption. The present situation seems to me, if anything, a little on the other side. Consumption has been pulling up strongly over the last several years without as much investment as you would think would be going with it.

Mr. Andersen suggested we are getting too much of a bunching on durables. It seems to me that in principle, with the help of proper tax policy and proper monetary policy, there is no reason why you can't keep consumption and investment going along together pretty well within a fairly wide band of fluctuation, as between the emphasis on both of them.

On the other hand, it is pretty clear that at some point you can get too much investment for the amount of consumption and you just are going to lose the incentive for more investment.

I think economists make a mistake when they pretend to know more than they do know about how wide that band is. I think here is a place where we can adjust our monetary fiscal policies to influence whether we want more investment or consumption. I would put this in terms of the long-run growth pattern. Do we want rapid growth, if so, we want more investment.

I see no reason why in principle we can't have both the rate of growth that we want and an equitable distribution of the current goods in the way we want, and at the same time maintain stability in that growth rate.

Here are three major considerations. In principle I see no reason for the conflict that is so often emphasized between these things.

Senator DOUGLAS. Thank you, Mr. Chairman.

Mr. MILLS. Senator Goldwater will inquire.

Senator GOLDWATER. I just have one question to ask of Mr. Andersen.

In your discussion of inventory level, have you ever determined on a formula that would indicate the level above which it might be dangerous to go?

Mr. ANDERSEN. I have developed a formula and a rule of thumb. However, it is one of the less reliable of all of the predictions I made.

My rule of thumb roughly is a 48-day supply. The automobile industry works on a day-supply basis.

I think that is true of many business firms.

Taking total business inventories and dividing it by total business sales, you had a 50-day supply of goods in 1951 and 1952 and then it dropped down and we liquidated some inventory in 1954, and then the great growth in consumption in 1955 brought inventories down to a 45-day supply, and it has stayed there, and I think it will be relatively low for another 6 months. Thus inventories are below my estimated normal level of 48 days.

Now as you remember the end of 1954 people were not worried about inventories being excessive.

Inventories had been cut. They had been cut too far and some production schedules were raised indicating that business was unsatisfied with their inventory position.

At that time they had 48-day supply.

Now, my projections indicate we will be back into about a 48-day supply in the third quarter or in the second half. At that point business having built up inventories from a 45-day supply to a 48-day supply will cut back that production which has been going for inventory build, and they will only produce for current sales then.

They will be generally satisfied with their inventories.

Then when you cut back that portion of production going for inventory build, it has something of a deflationary effect.

Also, the consumers will be saving at a higher rate. Consumers in recent years saved around $20 billion a year and this year savings dropped down below $16 billion in the third quarter. I don't think that is a normal situation. I think that consumers are going to save $20 billion annually, or 7 to 8 percent of their income as they have over

the past years, and also the fact that they have contracted for these debts means that they have got to save more.

They take these debts very seriously and I am sure they are going to make these payments, and so the contract entered into and normal saving pattern indicates that savings will be rising from a level of $16 billion, fourth quarter of 1955, to a level of $20 billion or $21 billion, fourth quarter of 1956, so we have 2 forces of deflation, or let's say easing, building up.

The day's supply rising from 45 to 48, and the debt repayment rising from $34 billion to $38 billion and in that situation I would not be worried, let's say, beginning with the third quarter of 1956 about a $3 billion cut in consumer taxes, to get some kind of a boost in consumer spending in the last half.

Let's wait as long as we can to cut taxes. If we get a sharp rise in wage and salary rates in the first half we may not need tax reduction.

In other words, if you get a rapid increase in wage rates, that would provide you with a big enough increase in consumer spending, and you won't need any tax reduction.

However, if wage rates rise at the rate of, let's say, 2 to 3 percent a year, which has been the past trend, I think under those circumstances you would get only an $8 billion rise in income, with a $4 billion rise in savings, that that gives you only a $4 billion rise in spending—1½ percent.

I don't think a 1½ percent growth in consumer spending is adequate, or in proportion to the growth in our productive capacity, so I would say at some stage of the game, and at the moment it looks like July 1, some tax reduction would be needed if we want to have full employment and stable prices.

Senator GOLDWATER. That is all that I have, Mr. Chairman.

Mr. MILLS. Mr. Curtis will inquire.

Mr. CURTIS. Mr. Bach, I would like to pose a question. I hope I can explain what I mean. It is a simple question if you get the meaning of it. Do you regard inflation as a form of taxation? And by taxation, I would mean simply a method whereby money goes from the pockets of the people to the Government.

Mr. BACH. Yes. Basically, inflation is a means of allocating resources, or transferring resources, just as taxes are a means of doing that. The Government, to me, is nothing but an intermediate stage. It is a question of who gives to what, so to speak, or who gives to whom through the Government, so we need to look at taxation as a form of getting resources, real goods and services, away from some people so the Government can use them to build battleships or give old-age pensions, or whatever it happens to be.

In that, sense, yes, I do believe that inflation is a form of taxation.

Mr. CURTIS. That was the sense in which I was asking the question.

Now to examine that a little bit further, of course, all inflationary or deficit financing may or may not actually create a deflation, because it is only one of many pressures.

Mr. BACH. Yes.

Mr. CURTIS. But would you agree that it is the basis, or one of the primary inflationary forces, deficit financing, not over one particular year, as we were discussing yesterday, over a cycle, an economic cycle, if you operated on deficit financing.

Mr. BACH. I would agree there have been, so far as I know, no major inflations, really big ones, in the American economy, without having substantial deficit financing as part of the inflationary process. I would like to make clear that we are talking about words where you and I may mean different things, as to what we mean by major and minor.

Mr. CURTIS. I wondered about that, and also about what we might mean by even the word "inflation," so far as that is concerned.

Do you know whether there have been studies made of the relation of actual inflation, which I possibly might state as being a decline in consumer price index—maybe that is a way of getting it across—of the relation of inflation to the Federal debt?

Mr. BACH. There have been a number of studies made of different inflations in which the existence of a Federal deficit is one part of the study. I know of no study that has just examined those two things alone. I think that the general conclusion I stated is the right one, that you have had small fluctuations in the consumer price index in the order of magnitude of 5 or 10 points, without any possibility of tracing those in any direct sense to an increase in the money supply through a big deficit. If you take the two postwar inflations, there was preceding each a large Federal deficit. Whether you want to call that a cause is another question. I would prefer to put it, it has been a necessary condition.

Mr. CURTIS. I see. The complete analysis has not been made. It may be the primary cause or it may not be. You are simply saying that it hasn't been determined if it is.

Mr. BACH. It hasn't been and I am not sure it can, because the process of inflation is a very complex process that acts through the spending decisions of consumers, businessmen, and of Government. In the big war inflations, including the suppressed one of World War II, it is indeed Government spending that has been a big part of the total. But if you look at the postwar period, say 1947–48, the sharp rise in prices—I have forgotten my exact months there—this, in fact, was not a rise directly attributable to Government spending. Indeed, it was quite the reverse. Government spending was down but still there had been that large amount of money supply piled up during the war as a result of the Government deficit.

Now I would say, not that the Government deficit was the cause of the inflation, but that if we had not had such a big Government deficit piling up the money supply, it would have been very difficult, indeed, for consumers and businesses to have spent at the excessive rate they did after the war and hence have caused the inflation.

Mr. CURTIS. Of course, in considering it, it isn't actually a Federal debt. It is the Federal debt in ratio to something else, whether it is, as people say, gross national product. Do you know what studies have been made along that line by economists, to what to tie the Federal debt to in order to get an estimate of the economic effect that it is causing? Is it usually gross national product?

Mr. BACH. I think there have been two different approaches to this: One approach is to try to relate the size of the Federal debt and the interest burden on the debt to the current level of income, on the notion that if the debt gets quite large relative to current income, then the tax burden just to pay the interest on it becomes a burdensome thing. On the other hand, if income is rising at least as fast as the debt, at

least the relative impact of the servicing of the debt is not larger. This is a rather vague way of putting it, but a rather sensible one, I think.

The other approach is to look at the money supply and to say that in a growing economy you probably need to have an increase in the money supply, roughly in proportion. It is often said the economy grows at about 3 percent a year in terms of total output, or maybe 4. I don't think many people would argue you have to have just that rate of increase in the money supply, but it is pretty clear you ought to have roughly that rate. Where are you going to get it? There is one possibility, at least, of arguing that unless it comes out of the ordinary course of business borrowing, consumers and businesses, the Government might indeed—and this is a very odd doctrine in terms of traditional finance—the Government might indeed borrow to create money, and this would be a test, one criterion.

Mr. CURTIS. You use money to include credit?

Mr. BACH. Yes. Bank credit is the major part of money.

Mr. CURTIS. Now one other proposition: The inflationary effect of the Federal debt—I will put it the way I presume and then ask you to correct it if it is not so—becomes greater as the ratio in relation to GNP is greater; in other words, if we had a low ratio, the inflationary effect wouldn't be so much, but if the ratio were higher, whether it would be a geometrical proportion, it would be more than arithmetical if the other were there.

Do you agree with that, if you follow what I am trying to say?

Mr. BACH. I am not sure I do understand.

Mr. CURTIS. Let me pose that all over again. Suppose we had a ratio of—let's take what our Federal debt is now, around $280 billion, and what is our GNP?

Mr. BACH. Almost $400 billion.

Mr. CURTIS. Say it were a 20 to 40, and suppose—and I wish I had actual figures—suppose it were at one time 5 and 20, which is 1 to 4, as opposed to 1 to 2. Each billion dollars of debt on the 20 to 40 ratio would have more inflationary effect, as I see it, than each billion dollars put on at the time the ratio might be 1 to 4, or do you know?

Mr. BACH. If I understand you, I think you are correct. If I understand what you are saying, it is that the issue of the importance of the Government debt is partially a function of how large it is relative to the gross national product. I think it is entirely correct, but it is by no means the entire problem. May I make another point?

Mr. CURTIS. Yes, sir.

Mr. BACH. One problem is who holds the Government debt. We need to look behind this now, because the thing that is worrisome about the debt at any moment—say today, it seems to me, is not the absolute size or in itself the relative size, but if you like the servicing problem on the debt. There is now, I think, something like $7 billion of interest charges on the debt per year. This represents in one sense only a transfer payment. You can say it is out of one pocket into another. This is too easy, because there are different pockets. It is a pretty important question as to who gives it up and who gets it, so I would put that as the way of facing the problem in the light you are doing it.

I would put the problem of the money supply as a very important problem over the long pull as a possible criterion. Then I would make the third point, if I could, that at any moment, the question as

to whether the debt should be raised or lowered ought to be primarily a question of its impact on the current level of economic stability; that is, whether we are in an inflationary or deflationary period.

Mr. CURTIS. To pick up the other aspect of your paper, as I saw it, which is getting down to the question within the society itself, whose pocket it comes out of, and that is where, as I get it, you point out the inequity as between groups.

Mr. BACH. Yes.

Mr. CURTIS. I notice that you say that the inflationary trends occurred, or were borne largely by the retired people and older families, and then well-to-do families with net worth over $25,000.

Actually, those well-to-do families have pretty good hedges, don't they? They can, because of their control of investments—and they are not just consumers, they are investors—they can put into equity investment and so ride inflation, can they not?

Mr. BACH. They are certainly in a much better position to do this than the poorer family.

Mr. CURTIS. The person whose dollar goes practically all for consumption.

Mr. BACH. On the other hand, if I may call your attention to a table on page 80 of the green document that you have, it is interesting that they have done rather better than older people and retired people at protecting themselves this way, but there isn't as much of a difference as you might think. If you will look at the table, may I draw your attention to the bottom line of the table, in which there is a column headed "Monetary assets," and a column headed "Variable price assets." Variable price asests are things like stock, houses, real estate, things you would expect people to buy to protect themselves. They hold 77 percent of their assets that way, but 23 percent are in monetary terms, whereas if you will go up here—those are the old people—if you will go up and look at these well-to-do people who ought to know better, so to speak, and can take care of themselves, you will find that the ratios are not enormously different. They are somewhat different but not a lot.

Mr. CURTIS. Of course, you will find in, for instance, your charitable organizations, their portfolios, like colleges, are going more and more into equity investment just for that very reason. Some of this lag in going ahead with this hedging may have come from traditional investment policies that the fiduciaries were unable to go into. I was intrigued with your comment that you felt that the impact wasn't quite as bad, because what they lost from inflation, due to the financing of the funding of Federal debt, it came back.

I raise this point: It doesn't come back to the public as a whole. It comes back to the taxpayers, and the lowest income groups are not taxpayers. In fact, your old people on retirement are, generally speaking, not taxpayers, and so they get no break at all in that, if it comes back in the way of a tax benefit.

Mr. BACH. Well, this is, I think, a very tricky point, and one in which I confess my mind was not straight until I set to work on this. The point you make is the one I started out with, that inflation transfers real purchasing power between the bondholder who loses it and the taxpayer who gets it. I think this is not correct, by and large. It

is correct in one part, insofar as the interest on the debt is concerned. If inflation occurs, the taxpayer has to give up less real purchasing power to pay his debt to the bondholder in form of interest. On that score, there is no question that you have this loss to bondholders and again to taxpayers, and your point would be correct.

But now consider the point where the debt is just refunded over and over. We are now asking the question about not the interest on the debt, but the debt itself. Now, if the inflation occurs, it certainly is true that the bondholder loses. When the bond comes due and is paid off, obviously he gets less real purchasing power.

Who gains? I think the public as a whole does gain in this case, and let me put it this way: Suppose, first, that that bond is refunded to somebody else; that is, Senator Douglas holds the bond, and Representative Mills buys a new bond, when the Government pays off Senator Douglas, Senator Douglas is worse off. There is no question about that. The question is: Is Representative Mills better off? I think not, because he hasn't gained. He pays for his new bond a dollar of current purchasing power for a dollar of bond. Who has gained? Well, you might say the Government has gained, because it has been able to pay off Senator Douglas with less, but remember, it is not paying off the debt. The Government has to borrow it again.

Can you chase that down from person to person and find anybody who has gained? I think the persons who gain are buyers as a whole. Senator Douglas now has less purchasing power to buy automobiles, stocks, potatoes, or whatever it may be. He can command less of society's resources, and everybody else whose earnings have risen can command more. In this instance I think it is the general purchasing power of the public as a whole that gains, in proportion to how much each part of the public spends.

Mr. CURTIS. I still suggest, using your illustration, this same group, who are on pensions, the older people, I don't see how they can come in for a gain under that, and particularly they are not in a position, most of them—some of them are, but generally speaking, as a class—to hedge against this through an equity type of investment.

Mr. MUSGRAVE. May I come to your rescue, if it is needed here? I think you are correct. I would say there are two ways in which you can look at this. If you think of the resulting problem of distribution in terms of real net worth, or something like that, what we ought to do is to capitalize the value of the tax payments needed to service the debt, and the real value of this capitalized liability of the taxes needed in the future to make payments. As the real value of this liability declines, we have a gain in the real net worth of the taxpayer. As the real net worth of bondholders falls, there is a transfer between taxpayers and bondholders.

On the other hand, if we look at the problem of distribution in terms of distribution of consumption, on the assumption that everybody were to disinvest, we would get a different result. It seems to me we ought to look at it in terms of real net worth, in which case I think Congressman Curtis is right.

Mr. BACH. I am not embarrassed about arguing with Mr. Musgrave. I have been doing this for years. Mr. Musgrave is, I think, quite correct on the point of the transfer of servicing charges. This was the first point I made. I think the real issue deals with the question of

the principal on the debt, and I don't think Mr. Musgrave is correct there, if I understand him. If we assume full employment in a society—let's do that to make it simple—now, our problem is, inflation occurs today, and Senator Douglas is worse off. His bond comes due. He is paid off in the cheaper dollars; Representative Mills buys the new bond, but he gets no gain to offset Senator Douglas' loss. Now, all I think you can say is that Senator Douglas now cannot command as much of society's full employment output as he could before, and that means there is more left over for somebody else.

The question, who else, is a question of who spends in society. You are quite right, I believe, in that the pensioned person, the old person, will not get his share of Senator Douglas' loss, although he may get a little of it, because it is going to be passed around some way. The basic notion that the gain is shared in proportion to the rate of spending of different groups in society, and this means that those who spend the most, well-to-do people, by and large, will gain most from Senator Douglas' unfortunate loss, and pensioners are probably not going to gain very much, although probably a little.

Mr. CURTIS. I am getting to my real question here, but I want to make one comment: I think maybe in my own mind, at any rate, I am differentiating between a dollar that is going to be used for consumption and a dollar that could be used for investment, and that is a very important factor, I think, because it is the people that have to use the dollar for consumption who have no way of hedging against this, because they have no way of protecting themselves, although the figures that they have on the other side, that they haven't protected themselves well as I thought. They are impressive to me.

We will be getting later into this problem of equity financing in corporations, but I have suggested for some time that one reason we had the great stock market rise came from a limited amount of equity capital and incentive on those who didn't have to spend their dollars for consumption, to take advantage of the 25 percent tax rate on capital gains, and at the same time take advantage in the corporations, avoiding paying of the 52 percent on borrowed money, as opposed to equity money, which seems to fit in here, but the thing I am getting to is this question of opinion from you: Can we have a little deflation which would—again, I am using the consumer price index, by allowing the dollar to buy a little more, which would get money back into the pockets of these pensioners and people like that—assuming we could have a little deflation, and at the same time preserve wages and salaries, would there be any economic drawbacks to that, to our economic welfare?

Mr. BACH. I think there would be some serious problems there, and they go back to the point that Senator Douglas was raising a while before, that we now have a system that is pretty rigid in a downward direction. The problem of reducing prices is a very hard problem. In the industrial field we have a large amount of price maintenance of various sorts, and in the labor field we have the same kind of thing.

Mr. CURTIS. But I presumed you could maintain salaries and wages.

Mr. BACH. You gentlemen know how painful it is when farm prices begin to slide a little bit.

Mr. CURTIS. Yet, if you can interject increased productivity in there, and that is where you might take some of this inflation out,

and another thing I would like to throw into this farm problem is the fact that I haven't run down, but I understand that the farmer today, 30 percent of his income is coming from nonagricultural pursuits, which is reflection of the fact factories are moving out into rural areas.

I do know that the per capita farm income has been rising recently very slightly, and not as high in relation to elsewhere, but it looks like it is coming to a large degree from this 30 percent.

If that is thrown into there and with increased productivity, could not a little deflation, which certainly would benefit, it seems to me, would benefit the people on the farm—I don't see how it would adversely affect these other groups.

Mr. BACH. I think there is in principle no reason why this could not happen as you describe it. This is basically the philosophy that was fairly common in the twenties, that the price level ought to fall gradually as productivity increased and wages ought to stay about the same. I can only say that I have grave doubts whether you would find organized labor willing to tolerate such a situation.

I think they basically want their wages to go up.

Mr. CURTIS. Organized labor would benefit if we could hold their wages and salaries and increase the purchasing power of the dollar. They are mainly a consuming group so I would think that they would be behind such a thing.

Of course, that is political and I am mainly interested in posing the question economically.

Mr. ANDERSEN. In regard to prices, let us keep in mind we change the product. We have this great new industry discovery. We keep changing the product, and while I suppose food perhaps to some extent doesn't change but what consumers are buying today are durable goods and services and things that are changed, and what is happening is the consumer is benefiting to a great extent by getting a better and better product at the same price.

Now, the automobile industry has found that consumers react more favorably to product improvement than price reduction. Let's suppose you get an increase in productivity and the industry picks up $20 a car on its profit margin.

They can say, well, we can do something with this.

We want to strengthen our competitive position. We can reduce the price of the car $20 or put $20 more into the product and they have found that the consumer reacts more favorably when they put $20 more into the car than when they reduce the price of the car.

One reason is, most people already have a car, and if you reduce the price of a new car, the price of used cars falls and it costs about the same amount to move up.

Mr. CURTIS. Yet, these European economy cars are getting quite a market in this country because of the price. The auto industry in this country has kept rising, doing exactly what you say, and finally all of a sudden you are getting a tremendous market for these cars that come in from abroad.

Mr. ANDERSEN. Well, about 50,000. This problem is under continual study, and the answer keeps coming out the same, that the way to stimulate demand and make the consumer happy is to change the product and not the price.

Mr. CURTIS. I think that might be for an automobile perhaps but not for a loaf of bread.

Mr. ANDERSEN. Not perhaps for a loaf of bread but durable goods are becoming a rising percentage of the total spending, and services are becoming a rising percentage. The Ford Co. got into trouble in the late 1920's because Henry Ford kept reducing the price of the car and this worked for a while but after a long enough period of time consumers incomes rose and he didn't want a lower price car but higher quality car.

At that point, Chrysler and GM came in and got the dominant position. That new trend which started in the middle twenties is still under way so when we talk about prices we have to keep in mind that we are selling the consumers different goods each year, and you can't compare the price level 5 years ago with today, because different products are being bought. Much of the consumer gain is coming, not through lower prices, or even stable prices, but through superior products. This complicates the problem.

Mr. CURTIS. What I mainly wanted to pose was this question: Here we are making a lot of talk about tax reduction, and my syllogism is that if inflation has been used as a tax and it has been hitting this particular group the most, I would like to figure out some way where any tax reduction could come that would benefit that very same group that was hurt and so I know a slight deflation—who was it, I want to get that term, yes, Professor Samuelson in his paper, refers to the "ready spending poor."

In other words, whenever they get a dollar in these lower income groups, it immediately goes out into consumption, and this is the group that seems to me were hit the most, and if that were so, that would indicate the traditional forms of taxation should not be lowered, that we should possibly pay off on the Federal debt, which in turn, if the syllogism is correct, would have a deflationary effect, and increase the purchasing power of the dollar.

Those are the things that I was posing in leading up to these questions.

I wonder if Professor Musgrave might comment on it. I don't want to monopolize the time up here, but let me get into it with you by asking a question I had here.

Isn't the inflation—if you do agree, it is a form of taxation, probably the most regressive form? Isn't it really a consumers' tax?

Mr. MUSGRAVE. Well, I would prefer to say that inflation is a redistribution scheme, rather than a taxation scheme.

Mr. CURTIS. If it is a redistribution it takes it out of the pockets of the people and puts it in the Government. That is all that tax is. We on ways and means are figuring out methods of getting money in Government's pockets and at least I feel we can do it through inflation and have done it.

Mr. MUSGRAVE. Or you might say inflation takes wealth out of some people's pockets, and puts it into other people's pockets. I think I would take Mr. Bach's results, which indicate that you could not generally speaking say that inflation is a regressive type of taxation, but that the whole pattern of its distributional effects is much more complex than that. That would be your finding?

Mr. BACH. Yes.

Mr. CURTIS. Wouldn't you agree it is a consumer's tax essentially, because it is reflected to a large degree in the price index, and the hedging, the methods of hedging against the effects of inflation, the investor does have.

Mr. ANDERSEN. The consumer is also a producer, and as a producer his incomes goes up and as a consumer his income goes down.

Mr. CURTIS. I am again harking back to this group of retired people.

Mr. ANDERSEN. They are worse off. It is a tax on them. There is no doubt about it. It goes to the producers, whoever gets higher wage rates, whoever gets higher profit margins.

Mr. CURTIS. Yet the earning people or the labor market can increase their salaries and wages. Incidentally, this gears right into our social-security system set up in 1936 and we have attempted through congressional action to preserve the social-security benefit payments that we had started with, but we haven't fully accomplished that by any manner of means. But social-security system I suggest has been one of the most badly hurt things by this inflation. That is the segment of our population who are benficiaries of the system.

You see all this talk of tax reduction has been all in terms of the taxpayer, and I know that the great bulk of our population aren't payers of the traditional tax.

Mr. ANDERSEN. The only thing that would help the group you have in mind is lower prices. They don't pay taxes and they are not producers. The only thing that would help them are lower prices, and that is not in the cards.

They can only hope for some improvement in the products they buy, but——

Mr. CURTIS. I have got the thing out in the open which I was trying to do. I don't know the answer, of course, and I was merely trying to throw it out for examination and I do appreciate your comments and your help in discussing this matter.

Mr. ANDERSEN. One vivid illustration, Mr. Harlow Curtice of General Motors has pointed out that the new Chevrolet is a superior car to the 1948 Cadillac.

Not prestigewise, of course, but intrinsically it is a better car than the 1948 Cadillac, and yet, the price is still substantially lower than the 1948 Cadillac, to which it is superior.

I think that is a dramatic illustration. They are now almost as long.

Mr. CURTIS. The fellow has both investing and consumer dollars.

Mr. ANDERSEN. This retired man can trade down from a Cadillac to a Chevrolet, and get a better price.

Mr. CURTIS. Thank you, Mr. Chairman.

Mr. MILLS. We are, as all of us recognize, on the subcommittee and the panel, endeavoring to find some broad principles that we may recommend to other committees of the Congress for the development of a tax policy that may promote economic growth and stability.

In your study of the impact of Federal taxation on the distribution of real income and levels of consumption, do you find that we have such a tax policy at present?

Mr. MUSGRAVE. This is——

Mr. MILLS. Mr. Musgrave, you may lead off if you desire.

I am directing it to all three of you but you may lead off.

Mr. MUSGRAVE. I assumed your reference to the title directed it to me. I would rather if somebody else answer it.

I would say that differences between the impact of various taxes on consumption spending excepting perhaps the corporation tax, are a good deal less than might be thought. Moreover, in a prosperous economy the impact of various taxes on total spending, including consumption and investment, differs less than might be thought. Thinking about tax legislation I would therefore concern myself primarily with the objective of obtaining an equitable tax structure and one that meets my objectives of social policy, and I would not let this be interfered with too much either by the consideration that we ought to tax this fellow more or less because we want to have a certain import on consumption, or that we ought to tax this fellow more or less because we want to have a certain impact on investment.

Basically, the objective of taxes is to hold down private demand, because if we didn't want to hold down private demand we could print money and finance Government expenditures that way.

We think that would be inequitable because of the inflation that results, so we do it through taxes. Therefore, let's not blame taxes for holding down private demand because that basically is what they are there for.

That is why we impose them, so I would say, the main consideration by and large in tax policy ought to be that of obtaining an equitable tax structure, sticking to it and being very skeptical about arguments which demand from us to interfere with these considerations of equity, because we want to induce consumption or investment.

Now, for instance, with regard to consumption, I would dislike an argument which says that in the depression we ought to have highly progressive taxes because this would hurt consumption less, and then by virtue of the same reasoning come to the conclusion that we should have a regressive tax system in the boom. Rather, we ought to be for progressive, proportional, or regressive taxes depending upon our social ideas, if you want our views of social justice. In other words, this is essentially an equity and social justice concept on which the economist has no particular opinion. Having decided on what we want, we should set up the tax structure acocrdingly and then stick to it, and get our effects on economic policy primarily by lowering the level of taxation in the depression and by raising it in the boom.

Mr. MILLS. Do we have enough built-in flexibility in our present tax structure to cause us to feel that we will in the future obtain a proper impact of Federal taxation on the level of real income and consumption?

Mr. MUSGRAVE. No, sir. I do not think so. Built-in flexibility, which I take to mean changes in tax yield in countercyclical fashion without adjustment in tax rates, is all to the good to the extent that you have it. But I see it's quantitative importance has been greatly overestimated. I think it is of tremendous importance for stabilization policy in our economy to set up a mechanism whereby tax rates can be adjusted fairly expeditiously. I do not think that we can at all rely on obtaining adequate changes in yield with constant tax rates. I think this has been greatly overemphasized. We have to face the problem of having to adjust rates with economic conditions.

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Mr. MILLS. In other words, you are saying that it would be good to increase the built-in flexibility of the tax structure of the future?

Mr. MUSGRAVE. It would be good to increase it, but do I not see how we could, unless we do something about the legislative and executive procedure which makes rate changes more easily. Otherwise, I do not see how we could think of taxes, new types of taxes, which inherently have a much greater degree of built-in flexibility in the automatic sense than the one which we have now.

I do not think that this is a possible direction in which to reform the tax structure because the only tax which really has a much more built-in flexibility than other taxes is the corporation profits tax, which is already at an adequate level, I suppose.

Mr. MILLS. Am I correct that it is the opinion of the panel that our job of endeavoring to make recommendations for tax policy that will promote economic growth and stability is made difficult because of the possibility that over the projected period of time, monetary policy itself may work counter to the purposes of tax policy?

Mr. MUSGRAVE. I hope that this will not be so. I would hope that both can work in the direction of stabilization policy. However, I do not think that monetary policy can do the job alone, certainly not if we should get into a severe recession, nor can it do it all with regard to checking inflation. I would say, for instance, in connection with Mr. Andersen's statement, that it might well have been better for the economy if, during the last year or two we had had more Government deficit and less consumer deficit.

That is to say it would have been better if we had had selective credit controls, and taken up part of this demand in Government debt, simply because Government debt is less dangerous to the economy than private debt.

Mr. MILLS. Are the two policies at the present time, tax policy and monetary policy, working in the same direction, toward economic growth and stability?

Mr. MUSGRAVE. I think there is an awareness in both that they both have to be part of stabilization policy.

Mr. MILLS. Isn't there a conflict at the present time in the two?

Mr. MUSGRAVE. Let me put it this way. In any given situation, you can always have a combination of policies. For instance, you might have a very high level of taxation combined with a very easy monetary policy and you might have a very restrictive monetary policy combined with a very low level of taxation.

In other words, both tax policy and monetary policy operate on your total level of private demand, and so they have to go with each other. I would say you have contradictory policies, only at a time at which, in a situation where total demand ought to be restricted, you have at the same time tax reduction and easing of monetary policy.

As long as you have tax reduction together with restriction of monetary policy, in a situation where total demand ought not to be increased, the two might just offset each other.

Mr. MILLS. The statement is frequently made, Mr. Bach, that the present tax system represses economic growth and the only reason the economy has continued to grow since the end of World War II has been the stimulating effects of inflation, mild or whatever it has been.

Do you think this statement is correct in view of your statement in conclusion that relatively mild inflation does not stimulate an increased total real output?

Mr. BACH. I think the statement is incorrect. It is true that taxation is a repressive force. This is the nature of taxation, but to say that the thing that has made us grow is the inflation seems to me to be without basis insofar as I have been able to assess the evidence. As Mr. Musgrave points out, the function of taxation is to be repressive. You have got to get the money away from the taxpayer some way.

Mr. MILLS. Do I reach the conclusion, then, that it is your opinion that the present tax system does not repress economic growth but that it has permitted or made possible the economic growth that has occurred since the end of World War II?

Mr. BACH. I don't want to be evasive but I don't quite like the way the question is put. I find it hard to answer in this form.

Mr. MILLS. Pardon me for interrupting, but the point that I am trying to reach is this: If present tax policy is conducive to the type of economic growth that has occurred since the end of World War II and has been responsible for that growth, then it would not necessarily need much modification, but if it has been repressive, and we could have grown more with a better tax policy over the same period of time, then I would want to know what changes we should make in tax policy.

Mr. BACH. May I answer it this way. We could probably have grown most by not having any taxes at all. It is in that sense that all taxes are repressive. Now, I think that one can safely say that the tax system we now have is consistent with a rather rapid rate of growth. We have seen the evidence on this over the last decade or so.

It seems to me we don't want a maximum rate of growth. We want an optimal rate of growth. There is nothing good about a very rapid growth in my mind. This is a question of how much our resources we want to use in supporting our standard of living now, and how much we want to devote to the future. The way I want to answer your question is the present tax system has been consistent over the last decade with the rate of growth we have had.

Whether this is the right rate of growth or not is, it seems to me, a question that goes beyond my professional competence as an economist. I think it is about right, but we could get a more rapid rate of growth with different tax system and different monetary policy. This is the point Mr. Musgrave was making, I think.

The first question you need to ask about the tax system is, is it equitable? You can then get full employment with any distribution of the tax burden, it seems to me, or almost any distribution of the tax burden, by running a big enough deficit or surplus. That is, the absolute size of the total deficit or the total surplus is the crucial question, I believe, for whether we have more or less unemployment, and this is not completely separate, but is in considerable part separate, from the exact composition of the tax system which ought to depend on equity considerations.

The third point is with reference to your growth problem. Here, to be sure, you get more rapid growth if you put your taxes primarily in a way that permits rapid reinvestment of profits or this kind of

thing. Here, it seems to me is where monetary policy especially comes into the picture. I would use monetary policy not only for these short-run fluctuations but particularly in terms of the rate of long-run growth that we want. If we want rapid long-run growth we had better have a low interest rate, and we had better have easy money for business investment.

It seems to me that those three questions are all related, but to some extent separate, and there is the possibility of maneuvering them in a cooperative way. Thus, I suggest that this is the real meaning to your question about the relationship between monetary and fiscal policy. The issue is in my mind whether the people in the Federal Reserve and the people in the Treasury are working and planning things out effectively together, not whether interest rates are being pushed up at the same time as, say, taxes on consumption are being lowered.

Mr. MILLS. Also, whether the planning is in the long range or for short range only.

Mr. BACH. Yes.

Mr. MILLS. Would you give me more of your description of an equitable tax policy? Equitable in what respect, and among what?

Mr. BACH. I will give it to you but I must preface it by saying as an economist I don't think I have any special competence to do this.

Mr. MILLS. I don't mean in detail. I mean in general, as between consumption and investment or between something else.

Mr. BACH. I would say basically, there are 2 or 3 points that have to be faced. The first is, which I think has general acceptance, that something like net income is the best measure of the individual's capacity to pay, and the capacity to pay is the strongest general guide we have to the distribution of the tax burden. This denies for example, the benefit propositions, that people ought to pay taxes primarily because they immediately and directly benefit from the expenditures financed by the taxes.

I would say secondly, that people in similar positions ought to be treated similarly, and it seems to me that our present tax system is beginning to wander rather far afield on this. That is, that if you take people with similar income positions, we now have a variety of provisions in the tax law that in my judgment are inequitable because they do not follow the principle of treating people similarly circumstanced in substantially the same way.

These are the two guiding principles I think I would set forth. I would not make the point of the distribution between consumption and investment a critical point.

One thing that follows from my proposition is that the test of an equitable tax system is its impact on individuals, not on businesses; that we must look through the business firm, through the corporation, to who really pays the taxes in the end if we want to decide whether they are equitable or not.

In fact, this reasoning leads us in the direction of much heavier use of personal income taxes, and much less use of corporate income taxes and of excises, if you accept my basic proposition about equity.

Mr. MILLS. In the long run, then, should tax policy for economic growth and stability consider more the elimination of inequitable situations than merely reductions in rates?

Mr. BACH. I should think so. I would put this as my first test as to revising the tax system. Then I would decide the question of rate revision in an aggregative sense on the overall level of activity in the economy; whether we are having danger of recession or danger of inflation.

Mr. MILLS. In other words, one of the basic principles that the committee might well consider in recommending a tax policy for long-range growth and stabilization would be the attainment, if possible, of an equitable base for tax. That is, using the word "base" loosely, and then attempt, as situations in the future suggest, either to raise or reduce the rates.

Mr. BACH. Yes, with as much built-in flexibility as you can get, but I agree with Mr. Musgrave it won't be enough if you get serious deflation.

Mr. ANDERSEN. Since you have business cycles within a 12-month period I think one of the features of tax policy should be that rates should be subject to change more than once a year. For instance, in 1953, the first half you had inflationary pressure, the second half you had strong deflationary pressure. We are getting some 6- and 9-month cycles, and I think that tax rates as part of your policy for economic stability should be subject to change more than once a year, and secondly, the rates should be moving downward, tax rates should be moving downward consistent with stable prices. If you can see your way clear to get a reduction in rates that will not be inflationary, I would say that that would be another feature that would contribute to economic growth.

Mr. MILLS. Mr. Andersen, maybe I can ask this question of you. You point out that we will have a gap between production and consumption, beginning, say, July 1, 1956.

You offer the suggestion that at that time it might be well for Congress to increase the capacity of consumers to buy by reducing taxes in some manner.

Mr. ANDERSEN. That is right.

Mr. MILLS. I assume that there is somewhat general agreement among the panelists on Mr. Andersen's projection for 1956; is there?

Mr. BACH. I don't know. If I may say so, I think that maybe Mr. Andersen doesn't know, either. I think economists are prone to overrate their ability to forecast.

Mr. MILLS. He uses some figures that are most interesting and of course if the figures are correct, his conclusion will be correct.

I noticed he doesn't take into consideration, however—or at least, I didn't understand that you did—the possibility of change in inventory policy.

Would that have any effect or bearing upon your projection?

Mr. ANDERSEN. I think there will be a change in inventory policy.

Mr. MILLS. I think so, too.

Mr. ANDERSEN. I think the current policy is to build inventories; by noting what inventories have satisfied business firms in the past, I conclude they will be dissatisfied with a 48-day supply, and looking at the production schedules for the first half of 1956, which we now have pretty well set up, because we have their orders, we have their intentions, looking at their production schedules set up for the first half of 1956, apparently they will have moved from a 45-day supply to a 48-day supply by the end of the first half.

If they are satisfied with their inventories at that point, then they will cut back that production which has been going for inventory build, and hold production to the level of consumption.

Now, I would agree that you can't forecast the second half with a high degree of reliability, and so we don't have to make a decision now. Decision can be made some time in the second quarter, perhaps late in the second quarter.

Mr. MILLS. Mr. Andersen, the difficulty always is this: Whether the Congress is safe in relying upon forecasts for tax decision, or whether the Congress should wait until the trend is under way for tax decision.

Mr. ANDERSEN. I think the Congress probably has to take a conservative position, and being practical, they have to wait.

Now, I do consulting for some eight different firms and they cannot wait. They have to set up their production schedules, and they want from me an estimate for the next 12 months, and so I have to give them numbers, because they in turn have to set out numbers. They have to forecast. You do not have any choice, and whether it is reliable or not, you still have to do it, and so——

Mr. MILLS. Businesses have more built-in flexibility than we now have in tax law; do they not?

Mr. ANDERSEN. Yes, but I would still like to see more. I think we can all be proud of the increase in stability that our economy has shown. We can be very proud of that.

Mr. MILLS. Oh, yes.

Mr. ANDERSEN. It is something to really brag about. On the other hand, we admit that we are not perfect and I think that these suggestions are aimed in the direction of further improvement.

Mr. MILLS. You are emphasizing again the importance of as much built-in flexibility in tax structure as can be gained.

Mr. ANDERSEN. Yes. One of the features would be increased frequently in change of tax rates. I don't think you can set tax rates once a year and cover a 12-month period accurately.

We have great momentum in our economy. We don't go up and down every 2 or 3 months. We have so much diversification that we do have momentum and I think you can forecast within 1 percent, 6 months ahead. I have always been able to forecast within 1 percent 6 months ahead. Beyond that, it is more difficult, but your staff I am quite confident can forecast 6 months ahead, with a very high degree of accuracy.

Mr. MILLS. If you are right in your projections, and there will be this gap, that will be a downturn in business activity, or the beginning of recession or whatever it may be called, resulting from inability to consume what can be produced; is that right?

Mr. ANDERSEN. Yes. They will be paying off the debt at the rate of $38 billion a year. That is a very heavy level of debt repayment. Now that is a temporary condition. I think by the end of the year, you are going to have these debts worked down, or at least over 12 months, some of these debts will be worked down and paid off and then in the succeeding period, more of income will be available for spending. Of course, at that time production capacity—I think at the moment this looks like a one-shot deal. I do not think you have to successively reduce taxes by $3 billion every 6 months or every year. We did have

an exceptional period in which consumer loans rose something like 35 percent in 1 year. That was a very sharp increase, and we are going through a period of adjustment.

People are going to have to pay this back. This is a temporary situation, although it could recur.

Mr. MILLS. What I was leading to is this: if there needs to be the reduction of $3 billion in tax revenues, if your projection is correct, that would be a reduction then that would affect consumers?

Mr. ANDERSEN. Consumers; that is correct.

Mr. MILLS. Do you have any ideas as to how, if your information is correct, and your prediction correct, that reduction should be written?

Mr. ANDERSEN. I would probably suggest raising the personal income exemption, from, is it 600 now or 500 now?

Mr. MILLS. Six hundred.

Mr. ANDERSEN. Six hundred now—I would raise it to the point where consumer taxes dropped by about 3 billion.

Mr. MILLS. Dr. Musgrave, you point out in the paper that you prepared for inclusion in the compendium that there is very little progression in the lower income-tax brackets.

Would it be possible that a better way to provide such relief to make up this gap might be in the splitting of lower income brackets some way?

Mr. MUSGRAVE. May I just correct my finding? It was that there is little progression for the total tax structure, in the lower income brackets of spending units. Under the income tax of course there is progression even in the lower brackets. I agree with your suggestion. I would prefer to give this reduction, if we are to give a reduction to the lower income groups, by splitting the first bracket.

The $2,000 bracket would be split into two $1,000 brackets and we might reduce the rate on the first $1,000 to, say 5 percent.

I would prefer this to raising the exemption by maybe $125, which I take it is about what would be needed to get Mr. Andersen's figure.

I might mention that this is also proposed in Mr. Henle's paper. This is very interesting to note and I very much agree with it. My reason is that if we want to think of the income tax as our main vehicle of taxation, also in the lower income groups, then let's not throw large numbers of taxpayers out of the income-tax base. A policy of raising income-tax exemptions will in the end help the advocates of a sales tax, because you have got to tax the lower income groups somehow. If they do not pay income tax, why not have a sales tax? I want to keep the income tax as the main way of taxing these lower income groups because it is the fairer way to do it, and therefore would like to keep exemptions down.

Mr. MILLS. Mr. Musgrave, is it not true that the splitting of the lower income bracket, or even brackets, would tend to give you more built-in flexibility in your tax structure than an increase in your exemption?

Mr. MUSGRAVE. I wouldn't be sure of this offhand. I think you get your built-in flexibility by people moving in and out of the taxable range, and moving in and out of higher and lower rate brackets. I think they both work the same way.

Mr. MILLS. You get it also, do you not, by income itself moving in and out?

Mr. MUSGRAVE. Yes.

Mr. MILLS. Do you get built-in flexibility, though, by eliminating individuals from the structure of the tax?

Mr. MUSGRAVE. Well, if you raise the exemptions, perhaps more people would move past the $1,200 line than now move past the $600 line. I am sorry, sir. I think I would have to do some figuring on this. It would be hard to say offhand.

Mr. MILLS. I may not have made myself clear. The point is that to me one of the ways you can have greater built-in flexibility is to provide more progression in the lower rates versus the idea of maintaining the same progression in the lower rates, but just excluding more income from the incidence of taxation.

Mr. MUSGRAVE. Well, I am sure that if you were to maintain present exemptions, and split the first bracket into two $1,000 brackets, that that would increase your built-in flexibility; but I am not sure whether you increase it by splitting this bracket, as compared to raising exemptions. You may well be right, sir. I never thought about this particular aspect before.

Mr. ANDERSEN. If you restrict the relief to just splitting those brackets, which I think would increase the built-in stabilizing effect, you are limiting the relief to a certain group, whereas the demand for consumers goods may be pretty much across the board and you may need to stimulate consumer spending across the board, which may mean we should have tax relief to some extent across the board, rather than concentrating all the increase in purchasing power of a certain group who have a certain spending pattern. A particular problem may be durable goods. If that income group doesn't buy durable goods, you may have a problem there.

Mr. MILLS. I know we had agreed that one of the prime considerations, even ahead of tax rate reduction, is the equitable situation involved and the necessity, if we can do it, of greater built-in flexibility.

Mr. MUSGRAVE. Moreover, even relief in the lower brackets will extend to some extent throughout the income range.

Mr. MILLS. That is right.

Mr. MUSGRAVE. Congressman Mills, may I add one point? You said that the panel was pretty much agreed to this 3 billion reduction. I just want to say that I would not agree to it, until we have discussed the problem of public expenditures, which Mr. Andersen has not mentioned at all. It seems to me the question of the appropriate level of defense expenditures, the question of the need for extending certain nondefense services, such as education, and so forth, would have to be dealt with before I would agree to that conclusion. As a matter of fact, I don't think that I would agree after we had discussed expenditures.

Mr. MILLS. Let me see what it is you don't agree to, reduction in tax or projection of a balanced budget in fiscal 1947 that might permit of a reduction in the tax of $3 billion?

Mr. MUSGRAVE. I would say this way: If it was assumed that Federal expenditures will not be increased in the next fiscal year, I would agree that a $3 billion tax reduction would, as things look now, probably be all right. However, I wonder whether instead it would not be better to keep taxes and increase certain expenditures.

Mr. MILLS. Then we are in agreement, that is, the panel is in agreement, I take it, on this statement: If expenditures remain the same,

and the present level of economic activity continues during the coming fiscal year, there may be as much as $3 billion of surplus over expenditures. Do we agree on that?

Mr. MUSGRAVE. Yes; in the cash budget.

Mr. MILLS. I mean in the cash budget.

Mr. MUSGRAVE. Yes.

Mr. MILLS. Then we have in the Congress a proposition of determining whether we shall proceed on any one of three courses of action, or a combination of the three; do we not?

Mr. MUSGRAVE. Right.

Mr. MILLS. Namely, use of the $3 billion in tax reduction, the use of the $3 billion to reduce the public debt, or the use of the $3 billion to increase existing services, or provide new services of government, or a combination of all three?

Mr. MUSGRAVE. Yes.

Mr. MILLS. Now in the interest of long-run economic growth and stability of the people of this Nation, should that $3 billion be used to reduce the public debt, should it be used to reduce taxes, or should it be used to provide greater services and new services, or should it be used in combination of all three?

Mr. ANDERSEN. At the moment probably the increase in expenditures would take place in the area of public works, where we already have strong inflationary pressure. In other words, construction industry is at full tilt, and will probably move up again in 1956. The problem of increasing expenditures in that area, whereas more is certainly needed in the area of public works; construction contracts awarded and plans are high, that I am afraid that most of the increase in spending would result in an increase in the price level, whereas in the other sectors of the economy I do not expect industrial production—for example, I do not expect the same pressures in the area of manufacturing that I do expect in the area of construction.

Mr. MILLS. Let me ask the panel this: Would the panel agree that possibly there is a fourth alternative and that the fourth alternative is worthy of consideration? That these inequities that we have alleged to exist in present tax policy should be eliminated as the first step, though in the elimination and the adjustments that might occur, there might be some loss of this $3 billion of projected surplus in the cash budget.

Mr. MUSGRAVE. Yes.

Mr. BACH. Yes. I would agree with that.

Mr. ANDERSEN. Yes.

Mr. MILLS. There is a possibility there might be increase.

Mr. BACH. I see no reason in principle why the elimination of inequity should increase or decrease the yield.

Mr. MILLS. Even if it should decrease revenues, for long-range economic growth and stability, now is the time to do it, to make the adjustments.

Mr. BACH. I would like to see some such adjustments made.

Mr. MILLS. Are we all agreed?

Mr. ANDERSEN. Yes; but I would hope it would result in a reduction in Government yields if the pattern of the economy takes the trend I expect it to.

Mr. MILLS. It might result in an increase. But I say if there should be a decrease, we would still feel, the panel would still feel——

Mr. ANDERSEN. That the equities come first.

Mr. MILLS. Equities come first, and now is the time to make the adjustment.

Mr. ANDERSEN. It would be easier now than when the Government ir running a deficit.

Mr. MILLS. In your studies, is there any indication of the possible resulting impact of Federal taxes upon real income and level of consumption from applying some of the surplus to the public debt? Would that affect the situation involved in your studies?

Mr. ANDERSEN. Well, it depends, of course, on what type. I think there is more or less a demand for short-term governments, and I don't think I would want to see a contraction in the short-term debt.

The Government debt is desired by investment sources. Pension funds are growing, and others, and it is an excellent outlet for funds, and if you begin reducing the debt, you are cutting back one of the best sources of investment.

Now you can pay off the debt held by the Federal Reserve, some of that type of debt but I think you have to keep in mind that from an investment standpoint they are not totally against the Governments.

Mr. MILLS. I never thought of investors desiring the public debt and a continuation of the present level of debt to meet their desires.

Mr. ANDERSEN. That is one of the reasons why we are less likely to get something like we got in 1929. If the banks had held all those short terms in 1929, we wouldn't have had nearly the depression.

Mr. MUSGRAVE. Congressman Mills, it seems to me that the choice between (1) keeping expenditures constant and reducing taxes and (2) increasing expenditures with present taxes is one pair of possibilities. They are policies which fit more or less the same economic situation. Now, your other alternative (3) of keeping taxes and using the yield to pay off debt fits a different kind of economic situation. In other words, these are really not three alternatives to be chosen from in the same economic situation. The first two will be either neutral or stimulate demand, whereas the third one is likely to reduce demand, so they differ. Whether we want to undertake the third one or one of the first two thus depends on what the situation is.

If Mr. Andersen turns out to be quite wrong and inflationary pressures increase, then maybe using the surplus this way would be a good way of checking it, but it fits a different situation, as the other two cases.

Mr. MILLS. You anticipated me. I was going to ask your views with respect to the developing of a situation opposite to that described by Mr. Andersen.

I am faced with this problem always, of the time for paying on the public debt. Shouldn't any tax policy developed for economic growth and stability provide at some time for an excess of receipts over governmental expenditures to be used in reducing the public debt?

Mr. ANDERSEN. From 1946 to 1952 was the primary period for doing that, when you had a real inflationary gap. Now that you have moved to the new price structure and leveled off, I think it will be very difficult over the next 10 years, unless you have a war. It will be very difficult over the next 10 years to have any significant reduction in

debt. It is too late now. We had a golden opportunity and we missed it.

Mr. MILLS. You mean between 1946 and 1951, the debt increased?

Mr. ANDERSEN. No. That was a period in which the Government could have run a bigger surplus. That was the period to run the surplus, when you are short of goods.

Mr. MILLS. It could have paid more?

Mr. ANDERSEN. Yes. Of course, you can't do it during the war but after the war, when there is pent-up demand, you can.

Mr. MILLS. I wonder if we may have reached the conclusion that if we cannot hope to reduce the debt for a period of 10 years, because of our price structure, we might as well begin to think in terms of trying to live with this debt for beyond 10 years.

Mr. ANDERSEN. For ever and ever.

Mr. MILLS. At present levels.

Mr. MUSGRAVE. Assuming that the public debt is not increased, in 10 years from now the ratio of gross national product to public debt might be about the same as it was before the war. Certainly within 15 years it will be.

Mr. ANDERSEN. The debt is probably easier to bear, I think, than before the war.

Mr. MILLS. The ability to compare it depends upon the amount of interest we have to pay each year, and as we continue to pay more interest, because of the rate going up or because the amount of debt is going up, aren't we, at the same time making it less possible for us to use revenues of Government for services that people may need or desire; that if we reduced the debt, reduced the carrying charge, would we not then have more of our revenues for services that people may need and may desire?

Mr. ANDERSEN. But even if you paid off the entire debt, you only save $7 billion and GNP will rise over $12 billion in the next 12 months. Gross national product has risen $300 billion since 1929 and the servicing of the debt has only risen $6 billion.

Mr. MILLS. If we are paying only $6 billion on public debt, I doubt there would be so much desire for a pay-as-you-go highway program.

Mr. MUSGRAVE. Your point is quite right, but whether this burden gets heavier or not, as Mr. Bach pointed out, depends on what happens to the ratio of debt to income. That is to say, as the gross national product rises and we can hold the debt at what it is, the tax rate required to pay these $6 billion will fall, and so the burden will become lighter.

Mr. ANDERSEN. The taxes are paid pretty much by the people who make $5,000 or more. Before the war, we only had 3 million families making over $5,000 a year. We now have 20 million families. Over the next 5 years we are going to double the number of families who made $10,000 or over, so families are moving into these brackets where the tax rate is fairly high, and that, of course, tends to increase Government receipts.

Now if Government spending is going to be stable, that means that tax rates can be lowered steadily without having the Treasury suffer lower revenues.

Mr. MILLS. Am I to conclude, then, that it is the opinion of the panel that these general principles that this subcommittee hopes to develop,

or should develop, need not involve nor concern themselves with the question of reduction of the public debt within the period of, say, the next 10 years?

Mr. BACH. I guess I don't want to be on record quite as saying that, although I will say something that is related to that. It seems to me there is a principle that can be stated, and it is a very simple principle. The principle is, the public debt should be retired when there is a strong desire for deflationary pressure to be exerted on the economy. The public debt should be expanded if there is a strong desire for an expansionary force on the economy.

The public debt itself, that is, the level of the public debt itself, is not the first consideration. It may, however, become a powerful tool to help in maintaining stability in the economy.

Mr. MUSGRAVE. I quite agree with that.

Mr. ANDERSEN. I would select 1946 to 1951 as a good illustration of the period in which it should be. If we get another period like 1946 to 1951, we can reduce the debt in that period.

Mr. MILLS. Mr. Curtis?

Mr. CURTIS. I would hate to leave the discussion on this Federal debt at that point. I am quite alarmed at the way this conversation has gone.

Mr. MILLS. Don't accuse me of doing any more than asking questions.

Mr. CURTIS. No. Mr. Andersen, you were pointing out the need of a place for investment. Actually, if you can take the dollars that are in the Federal debt and put them into private investment, economically it doesn't make any difference, does it?

Mr. ANDERSEN. That is true, but a lot of individuals do not want to put all of their money in equities and private securities. I am in a program of trying to encourage people to buy common stock, and for a small investor, they want a certain amount of security, and they want a certain amount of their investment in Government's. Maybe they are wrong to feel that way, but that is the way they feel.

Mr. CURTIS. In other words, you are basing it on the investor's views on the thing. They want it, but actually let's disregard that psychological element, as far as the economy is concerned.

Mr. ANDERSEN. It is better to shift it to capital goods.

Mr. CURTIS. After all, let's illustrate.

Out in my area, Federal barge lines was an economic enterprise conducted by the Federal Government.

O. K. It was sold back to private enterprise.

Well, somebody had to dig up the $10 million, and maybe they cashed in Government bonds to do it. I think we ended up with a little healthier economic situation.

Mr. ANDERSEN. The same would be true of farm surplus. You can pay off that, use money to pay the debt and invest it in something else.

Mr. CURTIS. It gets back to a pretty fundamental thing that I was raising yesterday with the panel at that time. We just slurred over it right in the very beginning, I felt, and that is that it comes down to this question of how high the tax need be, because the base of all our problems is the fact that the tax take has just assumed to be high. Now on each individual item, whether it is public power, private

power, public housing, or other programs, comes a question of where should the investment be, in private or Government channels.

I don't see that economically it makes any difference who is spending the money in society as long as it is being spent.

Mr. MUSGRAVE. Would it be appropriate to ask you a question?

Mr. CURTIS. Yes, sir. I would be glad to have you. I am no expert.

Mr. MUSGRAVE. It seems to me that your argument is on the assumption that the investors would reinvest the proceeds which they get from spending the debt in private capital.

Mr. CURTIS. I assume this is investment capital.

Mr. MUSGRAVE. The argument is, I think, quite valid, but it does imply, doesn't it, that you would wish to transfer demand from spending on consumer goods to capital investment.

In other words, this would be a policy which you would advocate, because you would favor an economy that grows more rapidly and consumes less.

Then if that is your point, then follow it.

Mr. CURTIS. No. All I am saying is I think the consumption is out of this question. All we are talking at this particular point is assuming there is a certain amount of investment in society, investment dollars, whether it is a Government or private investment should not make any difference from the economic angle as long as it is investment.

All I am saying is you can reduce the Federal debt simply by the process, or you could, by taking it out of Government investment, as long as you felt your economy was such that it would go into private investment.

Mr. MUSGRAVE. But if you produce the additional capital goods, which the people buy, who hold the Government debt and if you do this in an economy which has high employment, then you must produce more investment and less consumer goods because you would not want to bid up the prices of existing capital assets.

You want to produce new ones. If I understand it correctly we can't leave consumption out.

Mr. CURTIS. Wait a second.

The Government in the Federal barge lines was just as much in the economic process as the private enterprise. The only thing was that there was nothing siphoned off in the way of investment.

You have Government in an economic enterprise. I don't see that it alters the picture as far as consumption of goods. They were contributing in the process of the economic process of manufacturing and distributing goods to the people.

Mr. MUSGRAVE. Yes. This is all right with the barge lines but retiring Government debt is not equivalent to reducing Government expenditures on Government barge lines.

Retiring the debt itself does not reduce Government demand, and therefore if this is to induce an increase in private demand for capital goods it must be accompanied by a decrease in private demand for other things.

Mr. CURTIS. No. All I am saying is just transfer the operation from one group to the other.

Possibly our area of disagreement is that I happen to feel that there are tremendous areas in which the Federal Government has

moved into fields of traditional private enterprise, which simply transfering of them out——

Mr. MUSGRAVE. I agree. To the extent this debt retirement would be offset by the sale of Government enterprises, that is all right.

Mr. CURTIS. That is all I wanted to interject. I did not want to get into the whole argument on the thing.

Mr. Chairman, could I ask two very specific questions?

Mr. MILLS. Yes, sir.

Mr. CURTIS. I wanted to clear up two things.

Mr. Andersen in your discussions on this repayment of consumer debt, in an expanding economy, isn't there a rather constant increase in the amount of consumer debt?

Mr. ANDERSEN. Yes, and there will be some further increase in consumer debt in 1956 of about one and a half billion dollars.

Mr. CURTIS. Over the 38 repayment?

Mr. ANDERSEN. Yes, for the year as a whole.

This year debt rose by $6 billion, consumer debt rose by about $6 billion, next year it will rise about $1.5 billion.

So you have a deflationary force of $4½ billion.

Mr. CURTIS. The ratio is less.

Mr. ANDERSEN. It is still rising. Over a long-term basis I would expect and hope it would go up over the long term.

Senator DOUGLAS. I take it that what you are saying is, the important thing affecting current demand is the change in the size of the increment or in terms of the calculus, dX, rather than X.

Mr. ANDERSEN. Yes. The increment will shrink in 1946. Over the long run I would still want it to be positive.

Mr. CURTIS. Taking up your use of volatility, there is a great flexibility in the consumer to repay, is there not, in this item?

Mr. ANDERSEN. Yes.

Mr. CURTIS. There is quite a bit of prepayment I meant to say.

Mr. ANDERSEN. That is right, prepayment: They usually do that. Usually people pay off debts faster than the contract calls for.

Mr. CURTIS. I have been very interested in seeing those figures on housing, where we worried about that in the savings and loan field.

A 15-year loan has an average payoff of around 7 and 8 years.

This is based on a few of the companies that I happened to observe, but in fact I understand in a lot of them they have provisions against prepayment, or at least a penalty.

Mr. ANDERSEN. Yes, to protect themselves.

Mr. CURTIS. I wanted to clarify that one thing.

Mr. ANDERSEN. On that change in volatility, for example, in 1929, when income fell, savings fell. People had so little income over and above necessities that when their income fell they had to reduce their savings, but by 1954, the situation had changed so much, income had grown so much that in 1954, when their incomes went down, their savings went up. They began to postpone this discretionary income and hold it, and so the great increase in income has led to a reversal in the savings pattern.

Previously savings were cut in the depression. Now they go up. That, of course, makes the situation worse.

Mr. CURTIS. I have one question I wanted to ask Mr. Musgrave or rather comment for his observation.

Senator Douglas was talking about real-estate taxes, and whether the workingman's home is taxed more than industrial properties.

I would make the observation that I think the real difficulty we have in the field is the new structures are taxed at the inflated price of the present day, while the old structures are through inertia and taxing procedures still assessed at the old figures, and industry does benefit because their investments, which are taxed, tend to be much older and workingmen's homes tend to be newer.

I don't know that is true but I am very much interested in our local situation where they are doing reassessment to find this tremendous inertia that exists in all of the assessors' officers, once they have assessed a piece of property, never to change it.

Mr. MUSGRAVE. This is one of the big problems of equalizing assessments in a property tax, which is administered on such a completely decentralized basis. In quite a few countries you find a centralized set of regulations, with regard to property tax assessments, which in that respect at least might have some advantage.

That is the problem.

Mr. CURTIS. In Missouri presently through State decree all the local entities have to do some reassessing.

Mr. MILLS. I have one further question I meant to ask you, Dr. Musgrave.

In your paper prepared for the compendium, as I understand it, you point out there is a sharp distinction between the incidence of Federal, State, and local tax systems; you suggest that this distinction has important implications for future trends in our fiscal structure.

I assume you mean that though the Federal tax structure is progressive State and local tax structures are regressive.

Mr. MUSGRAVE. Yes.

Mr. MILLS. By and large that is what you mean.

Mr. MUSGRAVE. Yes.

Mr. MILLS. Would you spell out what these implications may be?

Mr. MUSGRAVE. The thing I had in mind was this: That as the Federal budget increases relative the the size of the State and local budgets, the Federal tax structure increases relative to the size of the State and local tax structure. One of the important factors in the increase of the relative size of the Federal budget has been the enormously increased defense burden. Now let's visualize a happy future, where defense expenditures can be less and civilian functions of government can be expanded. On the expenditure side, many of these functions will be State and local, such as schools or health, and properly so. Yet if they are financed State and locally, this might lead to a very substantial gain in the weight of the State and local tax structure relative to the Federal and this might considerably change the composition of our overall structure. This is an important element to be considered in the whole interplay of Federal, State, and local finances in the future.

Senator DOUGLAS. I have a question, Mr. Chairman.

Mr. MILLS. Senator Douglas.

Senator DOUGLAS. If you had made a study of the distribution of the total tax burden in 1920, when State and local taxes formed a much larger proportion of the total tax revenues than they do now, then instead of getting proportionality, you now have approximate pro-

portionality between $1,000 and $10,000, you would have found a regressive tax structure.

Mr. MUSGRAVE. This would certainly be so if we applied the 1920 weights to today's Federal and State and local tax structure.

Of course, in the early twenties the Federal structure was different, the income tax was a much smaller part of revenue and the Federal structure was perhaps even more regressive than the State and local, due to the property tax at the local level.

The Federal tax structure then was a sales-tax structure.

Mr. MILLS. Mr. Andersen, just one more question: In a program of tax reduction, on the basis of your projections being correct some time after the 1st of July, would splitting the first income-tax bracket and reducing the burdens of taxation for low-income individuals by a flat percentage meet your situation?

Mr. ANDERSEN. Yes, it would be helpful. I would expect it to be, yes.

Mr. MILLS. Would there be a better way of doing it?

Mr. ANDERSEN. The package that you mention has the advantage of increasing the built-in stabilizers. I think it deals with the equity situation, and it gives some breadth in the relief, too.

It has three necessary features to it. You have to be practical here, and it gives you some breadth in relief as well as dealing with specific situations in affecting this question of built-in stabilizers.

I think I could support that. I would be happy with a thing like that.

Mr. MILLS. Senator Douglas?

Senator DOUGLAS. No questions.

Mr. MILLS. Mr. Ensley, who is the director of the staff for the joint committee, desires to ask a question.

Mr. ENSLEY. Mr. Bach, I just wanted to get my mind clear as to your position with respect to the immediate future.

If the present boom continues on through the next year, and construction and investment increase as has been reported, with unemployment continuing to stay at about 3 percent of the labor force, would you give top priority to using the emerging surplus resulting from present tax rates to retiring the debt?

Mr. BACH. That is the hard question of course.

Mr. ENSLEY. This is quite apart from changes in the tax structure to improve equity, but I am talking about——

Mr. BACH. I understand your question.

Senator DOUGLAS. You see we have to face these decisions constantly. You can avoid them but we can't avoid them.

Mr. BACH. I am not going to avoid it. I am trying to think of a good answer. My answer is in that case I would probably hedge by doing some of both. The situation you describe is one I would call a rather nice balance situation, where you neither want to encourage the upward movement very much because you are afraid you will run into inflation nor do you want to encourage the downward movement because you get too much unemployment.

It seems to me, frankly, that we are going to have a hard time keeping unemployment much below 3 million in an economy the size we have without inflationary pressure. I would interpret the situation you describe as being a little more of a problem on the upside than on the downside.

Therefore, yes, I think I would be inclined to use some of that surplus, at least, to pay off something on the debt. I would do it very cautiously indeed in the circumstances you describe.

Mr. MILLS. May I ask, what would the percentage be now?

Would you use a material part of it, or a very minor part of it?

Mr. BACH. Well, I would have to look at the details of the situation. Half and half, something like that, I suppose.

Mr. MILLS. Not over half?

Mr. BACH. Not as I understand Grover's situation.

Mr. ENSLEY. When would you make up your mind on it?

Would you wait until the trends begin to change, or would you make it long in advance?

Mr. BACH. My inclination is to distrust our ability to forecast. I would prefer to see us be pretty sure about what the situation is before we go around either cutting or raising tax rates. It is fairly easy if the Treasury ends up with surplus to retire some debt. That does not need any long advance planning.

Mr. ENSLEY. Maybe, Mr. Musgrave will comment on that also.

Mr. MUSGRAVE. If you have a surplus, and if you use it to retire debt, you are being on balance less deflationary than if you had a surplus and you are sitting on it. This is still an additional possibility.

One might argue that retiring debt as such is on the inflationary side; that the tool of deflationary policy is to collect taxes and create surplus in the Treasury. Moreover, you have the choice of letting the surplus sit with member banks or with the Federal, in which case you reduce member bank reserves and get more of a credit tightening. In a situation where further credit restriction is required, I think we ought to have it first on consumer credit. In other words, I would not enjoy reducing Government debt and letting consumer debt increase. It might be better in the kind of situation which you describe, to think about dampening the rising consumer debt.

Mr. MILLS. Mr. Ture, of the joint committee staff, desires to ask a question.

Mr. TURE. I would like to get the consensus of the panel on the proper relationship between monetary policy and tax policy in the short run and in the long run. I think Professor Bach suggested that for purposes of long-run growth, as an objective of public policy, it would be wise to have a relatively low interest rate policy?

Mr. BACH. If we wish to have a rapid rate of growth, yes.

Mr. TURE. Now take the short-run situation. Suppose we faced a set of boom conditions with a significant inflationary threat. How would you evaluate a combination of monetary and tax policy which provided for, say, tax ease and monetary restriction, as opposed to a combination of monetary and tax policy which provided for a somewhat tighter tax system and a somewhat less tight monetary policy for the short run.

I would like the views of all the panel.

Mr. BACH. As you describe the situation, I should suppose it would call for tightness on both fronts, that is, if you had an expansionary boom that was going faster than you wanted. The point at which you need this nice balancing I think is when you have just about the right amount of boom, but you still want the economy to grow faster. You want to shift resources from current consumption to long-run

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growth, and it would be at a point like that where I think you would make a very strong case for leaving the tax situation about where it was, but lowering the interest rate, to see if you can stimulate the growth side of the economy.

If you do that effectively, you are going to, of course, be running some inflation pressure. You will probably have to tighten somewhat the overall tax picture relative to Government spending.

Mr. TURE. Would you suggest, if you had an overall, long-range policy for a somewhat higher level, say, of investment, that you would gear monetary policy for the long run to whatever interest rate structure you thought was designed to produce that higher rate of investment and would make short-term adjustments in both tax and monetary policy for minor fluctuations?

Mr. BACH. I think so, if I understand your statement; yes.

Mr. MUSGRAVE. Well——

Mr. TURE. Would you agree with that, Professor Musgrave?

Mr. MUSGRAVE. I think I do. I would want to specify the question a little more; namely, what tax policy the monetary adjustment is to be compared with. Will regressive, progressive taxes, or our across-the-board change in present taxes——

Mr. TURE. I think we are talking about the latter.

Mr. MUSGRAVE. In the short run, your monetary policy is a good deal more flexible than your tax policy. For the immediate week-to-week, or even month-to-month action, it will have to bear the brunt. This is one of the great advantages of monetary policy, that it can be very sensitive to short-run adjustments. With tax policy, even if we make it a great deal more flexible, we will hardly ever get that far.

Then there is the question of structural maladjustments with regard to consumption and capital formation, which might require something like selective-credit controls at various times. Perhaps there is something to be said, if you want to be selective in some respects, for the use of credit, rather than use of taxes. Then there is a question, as Mr. Bach pointed out, that you have to decide what course do you want in the long run. A policy for rapid long-run growth would, by and large, be one of low interest rates, and regressive taxes. I am exaggerating, but that would be the direction. This is something to be decided on.

Then there is a final question to be considered in comparing tax restriction and monetary restriction, namely, what is the distributional implication of the one or the other.

Strangely enough, we talk a great deal about the incidence of taxes and what that does to income distribution. We have to restrict, we have to raise taxes; do we take regressive taxes or progressive taxes; how will they affect income distribution; what is the incidence of taxes? You get precisely the same problem with regard to monetary restriction and maybe one of the things we don't know very much about is what is the incidence of monetary restriction as compared, say, to the incidence of a proportional income tax.

Mr. TURE. Your standards of equity with respect to tax policy, I thought, were sufficiently important to embrace many areas of Government economic policy. Would you be concerned about these standards in connection with monetary policy as well?

Mr. MUSGRAVE. I think that would only be consistent; yes.

Mr. ANDERSEN. I would say that in order to encourage long-term growth, I would rely more on monetary policy and use tax reduction, too. While monetary policy has the advantage of being flexible—you can change your position from week to week—it hits the economy as a whole across the board, whereas sometimes you want to encourage one group and not another. For example, in 1954, business was more pessimistic than consumers, so there you wanted to encourage businessmen the most, and then you would reduce the corporate income taxes.

In 1956, business will be more bullish than consumers, and so in 1956 we don't have to encourage business so much, but we will need to encourage consumers.

Now monetary policy isn't well defined to encourage one group and not the other, but tax policy is. You can reduce consumer taxes without reducing corporate income taxes. Then in 1957 it may be that private investment is weak, but consumption is strong and so then you will need some tax relief to encourage private investment, so taxes have certain advantages in some ways. They have more flexibility, they are more selective than monetary policy, if you just make negative—if you just tighten up bank reserves, why, you don't know whether it is going to affect business loans, real-estate loans, consumer loans, or what. So you really need both, because one can do a job the other can't do.

Mr. TURE. Actually, the question was directed toward monetary and tax policy moving in directions opposite to each other. Should you, at a time when public policy ought to be directed toward dampening down an inflationary increase in the level of economic activity, have a monetary policy that moves in the direction of more ease and a tax policy that moves in the direction of restriction, or should they move in the same direction?

Mr. MUSGRAVE. You would make this perverse change only if you thought your previous mix of tax and monetary restriction was unsatisfactory, if you changed your idea about objectives, I would say.

Mr. MILLS. Without objection, the subcommittee will stand adjourned until 10 a. m. tomorrow.

(Whereupon, at 1 p. m., Tuesday, December 6, 1955, the subcommittee was adjourned, to reconvene at 10 a. m., Wednesday, December 7, 1955.)

FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

WEDNESDAY, DECEMBER 7, 1955

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON TAX POLICY OF THE
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The subcommittee met at 10 a. m., Hon. Wilbur D. Mills (chairman of the subcommitte) presiding.

Present: Senator Paul H. Douglas and Representative Thomas B. Curtis.

Also present Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The subcommittee will come to order, please.

This morning's session of the Subcommittee on Tax Policy will be devoted to discussion of the impact of Federal taxation on the amount and character of private investment.

As was announced yesterday, our procedure is to hear from the panelists in the order in which their papers appear in the compendium Federal tax policy for economic growth and stability.

At the start of each of these sessions, panelists will be given 5 minutes each to summarize their papers. We will hear from all panelists without interruption. Upon completion of the opening statements, the subcommittee will question the panelist for the balance of the session. I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee's questions.

Our first panelist this morning is Mr. Ralph E. Burgess, of American Cyanamid Co., New York City.

Mr. Burgess.

Mr. BURGESS. Thank you, Mr. Mills.

Business requires two kinds of investment: Fixed and working capital. The former is primarily plant and equipment, the latter covers inventories, accounts receivable, and liquid assets.

Over the last 8 decades, the average annual rate of growth of our economy was close to 2 percent and average per capita real income was multiplied over fourfold. If this growth continues at only the same rate for the next 80 years the average family whose income is now $5,000 a year will find itself controlling nearly $25,000 worth of purchasing power, a level now attained by only 1 percent of all families in the country.

While this tremendous rise in per capita income was taking place, it was paralleled by a similar expansion in the amount of employed

physical capital per person. More recently, because of inflation the physical expansion of business capacity has not matched expenditures for this purpose. It has been estimated that during the 1946–51 period, four-fifths of business expenditures for plant and equipment were for the replacement of outworn facilities and only one-fifth for new additions.

It is true that the amount of capital per unit of output has been declining since 1919 through increased efficiencies, but large amounts of new capital will continue to be needed. It has been estimated that in 1955 the total capital investment per worker in all nonfinancial business amounted to $12,500.

Current consumption of fixed assets is roughly $25 billion a year. Projected to 1965, total annual capital requirements are estimated at $40 to $48 billion (at 1953 prices). Another source places it as high as $60 billion.

New capital may be secured in two major forms: Borrowed and equity. Equity capital needs the greatest encouragement, yet is penalized the most by taxation. Under present tax rates undistributed net profit and depreciation reserves of business cannot be relied on to provide adequate funds for expansion. For the period 1946–51, only one-third of the reported undistributed net profit was available for financing additions to capital assets. This amount was only one-tenth of total business profit before income taxes. A 25 percent reduction in business taxes would have doubled the amount available for expansion.

Nor can the shortage of capital funds be attributed to an overliberal dividend policy, for the record shows that dividends have declined from 6 percent of gross business proceeds in 1929 to 3 percent in 1954.

A substantial part of the business expansion during and after World War II was financed by borrowing, so that corporate debt increased more than $100 billion from 1939 to 1954. During the same period only $18 billion of new money was raised by issuance of stock. This excessive reliance on borrowing places many business enterprises in a precarious position to weather economic storms.

Federal taxes are an important factor in the trend away from equity financing. Corporation taxes place a penalty on the issuance of stock, for full income tax must be paid on income used for dividends, whereas money used to pay interest on debt is free of tax.

Taxes, combined with higher living costs, have severely limited the ability of individuals to invest in equities. For example, in 1952, a single person with no dependents would have required an income close to $1,100,000 to yield the same real income after tax as a gross income of just $100,000 did in 1929. Individuals with money to invest have therefore sought low-yield but tax-exempt securities. Though such issues yielded only 2¼ percent in 1952, for an individual in the $100,000 bracket the net return was the equivalent of 19 percent before taxes derived from a taxable investment. Thus, in June 1953, nearly one-half of the privately held total of tax-exempt securities was owned by individuals. About two-fifths were held by commercial banks (in large part because of the tax-free incentive).

It is also significant that personal savings have tended to gravitate toward financial institutions. According to one study, in 1951 only about 8 percent of total savings of individuals went into equity securities. The bulk of the $19 billion personal savings of that year went to

insurance companies, banks, and mutual funds which, because of their conservatism and legal restrictions, invested relatively little in new stock issues. The outlook is not promising for finanical institutions ever to become major suppliers of venture funds.

The load of debt which industry is assuming is serious. When profits cease to rise and fall instead, as they must sometime in the future, the heavy debt burden will tend to aggravate and prolong any business recession. To further economic growth there is need for business expansion and it is unthinkable to continue a system of discriminatory tax rates which penalize and discourage business investment.

Corrective steps must include reduction of the high individual income tax rates, and a lessening of the degree of progression, together with further relief of the double taxation of corporate earnings and liberalization of the treatment of capital gains and losses. Plans might well be laid now, as has been proposed, to take advantage of the opportunity to reduce taxes as Federal revenues rise in response to an expanding economy. Each will facilitate the other.

Mr. MILLS. Our next panelist is Mr. Paul W. McCracken, professor of business conditions, school of business administration, University of Michigan. Mr. McCracken, you are recognized for 5 minutes.

Mr. MCCRACKEN. Mr. Chairman, the weight of empirical evidence and theoretical reasoning indicates that private-capital formation is relatively lower than when the share of national income absorbed by the tax collector was not so high. The change has, however, been astonishingly small in view of the fact that taxes now absorb almost one-third of our national income.

During the first quarter of this century our stock of productive wealth was apparently growing at the rate of close to 3 percent per year. In the postwar period the rate of growth has been closer to 2 percent per year. Moreover, according to Goldsmith's study, the trend of the ratio of national savings to net national product for the period 1897 to 1929, extended on to the postwar period, would give an average ratio of 13.1 percent for 1946–49, compared with the actual figure of 11.2 percent.

We must not forget that an increase in taxes can serve as a spur to capital formation.

1. Taxes used to finance certain types of public works may enlarge opportunities for private investment. A substantial expenditure for highway construction, for example, will be essential if continued large capital outlays by the automobile industry are to be justified.

2. An increase in taxes may require added capital outlays in order for management to realize some profits-after-taxes objective. This implies that the tax change would simply prod them into doing what all along would have been worthwhile.

3. Heavy taxes create the possibility of imposing on the Treasury at least a part of the cost of any risky venture which goes sour.

4. The present tax structure may create an incentive to retain corporate earnings after taxes, the volume of which is a factor in determining capital budgets.

The empirial evidence suggests that the disincentive tax effects, however, outweigh the incentive effects.

1. A tax structure which takes over half of corporate earnings presumably reduces the supply of funds for further expansion and growth.

The largest single element in the capital structure of most major corporations is retained earnings.

If growth of new firms is impeded, we are penalizing the small, growing firm at the expense of those who "have arrived." The factual evidence is unclear—mergers and the number of "live" businesses are in line with our national income.

2. A heavy tax alters the characters as well as the total volume of capital outlays. This has many dimensions. The attractiveness of long-term projects is reduced; residential construction is fostered; State and local obligations enjoy a tax privilege in the capital markets.

3. There are logical reasons for thinking that our heavy tax structure ought to reduce the amount of national income being saved. Our present tax system bears down particularly hard on those elements of income which are particularly important as a source of saving—corporate profits, and higher incomes generally.

Moreover, it can be presumed that a tax increase at any income level comes to some extent at the expense of saving.

If the factual evidence available is to be believed the great increase in taxes relative to national income has produced a surprisingly small displacement in the savings rate, though it has declined some.

4. Theoretical analysis supports the view that a heavy tax structure impedes capital formation. The theory of investment says that a business will undertake all capital-formation projects down to those whose expected rate of return is just equal to the cost of money.

If the cost of money is fully deductible for tax purposes, a project whose rate of return exceeds the cost of money on a before-tax basis will on an after-tax basis also.

But the cost of money in the real world is only partly deductible. For manufacturing concerns debt accounts for only a minor part of the capital structure. And even for public utilities good financial policy usually requires limiting debt to one-third (not over one-half) of total permanent capital.

Therefore, the imposition of a tax on corporate earnings does make some otherwise profitable capital projects no longer financially justified.

The conclusion to which these remarks leads us is that capital formation would, other things being equal, be higher if the total tax burden could be substantially reduced. This is not going to strike anyone as a particularly earth-shaking conclusion. It is, however, worth making. One of the costs of enlarging the Federal budget further may be lower capital formation, and a less rapid improvement in our standards of living, desirable as each such proposed new expenditure may be in its own right.

The immediate real-life question is slightly different. Given the modest elbowroom for 1956 tax reductions, what kinds of tax reductions might reasonably be expected to help sustain a high rate of capital formation? That a tax reduction will prove to be in accord with sound economic policy in 1956 is, I think, increasingly clear. The cash budget will by them be operating at a substantial surplus. And the 1956 economic situation will in all probability make a tax reduction of $3 billion or so appropriate. And now is the time to be making up our minds about the kinds of taxes which might be reduced next year.

Indeed, my own view is that we are in danger currently of exaggerating prospective inflationary pressures. Therefore, the question arises: What tax cuts should account for this $3 billion? It seems to me the following list represents a reasonable order of priorities.

1. The present uneven and heterogeneous array of excise taxes should be evened up and regularized. The rationale of the currently substantial differences in excise tax rates is difficult to see. This is largely a matter, however, of equity rather than of removing an impediment to capital formation.

2. The corporate income-tax rates should be cut at least 2 percentage points to 50 percent. If the tax is passed on in the form of higher prices, it is, in effect, a sales tax. If not, it comes partly at the expense of retained earnings the volume of which importantly influences capital formation. If it is at the expense of dividends, its impact is uneven and inequitable.

3. Lower personal income taxes should account for the remaining $2 billion to $3 billion of tax cuts. Whether this should be relief at the lower income end or at the middle and high-income end of the spectrum is a multi-dimensional consideration. It is clear to me that the interests of a high and sustained level of capital formation would be best served if an important part of this relief could go to the upper middle income range.

4. Two negative recommendations are also in order here.

(*a*) The greater flexibility in procedures for depreciation changes provided by the 1954 Revenue Act should definitely be retained. The evident sensitivity of capital outlays to tax policy with respect to depreciation justifies this (and it makes sense on other grounds, also).

(*b*) The differential treatment of capital gains should not be treated as a loophole and plugged. Or, rather providing a loophole may be good tax policy if it encourages desirable action as a side effect. This differential treatment apparently does help to maintain, even in a high-tax era, business venturesomeness and risk-taking.

Mr. MILLS. We thank each of you for your appearance this morning, and for the information you have given the subcommittee in the compendium and in your appearance today.

This morning I will ask Mr. Curtis to begin the interrogation.

Mr. CURTIS. I would like to first direct this particular question to both of the panelists.

I notice that the basis upon which many of these assumptions rests is a reference to the capital per worker. I think one of the figures here is $11,000 for the present ratio.

I noticed other papers and comments of persons not on this particular panel refer to capital per dollar output, and a case is made against the need for the great amount of additional capital investment on the grounds that the capital per dollar output has been declining, or to put it conversely, that the productivity of capital has increased to the extent that we no longer need the same amount of capital in order to gain the output we are all seeking, and yet this other basis of referring it to workers indicates an opposite trend.

I wonder if you gentlemen would discuss that a little bit to see if the two can be reconciled.

Mr. BURGESS. I should be glad to try to reconcile those two points of view, Mr. Curtis.

The facts are as you state them. The productivity of capital over the years has increased because of more efficient use of that capital, and the ratio of capital employed to output has been declining gradually.

If we could count on a stationary population and maintain only the status quo with respect to our standard of living, we could be content with present output in our economy.

However, we know that the population will expand and all desire a higher standard of living.

Therefore we do require greater and greater output over the years ahead.

In order to achieve that output, we shall need greater amounts of capital, despite increasing efficiency in its use. We shall need larger absolute amounts of capital, although relative to output the amount of capital employed may continue to decline.

Mr. CURTIS. Mr. McCracken?

Mr. McCRACKEN. Well, I think I have not much to add to what Mr. Burgess has said.

It is quite correct that actually since about 1929 the ratio of capital per worker has not apparently grown significantly.

Nevertheless, we know that the ratio of output per worker is substantially higher than a quarter of a century ago. This is another way of saying that the ratio of output to capital has been growing.

Now, the first point to make is the one that Mr. Burgess made. In an economy such as ours where the labor force is continuing to expand, a substantial amount of capital formation will be necessary just to sustain some sort of relationship between capital and the labor force. And of course the population statistics suggest that we are moving into an era where the growth in the labor force is apt to be substantially greater relative to the growth of the population than the one we are in right now.

The second point which I would make is that if we could have maintained the same rate of growth of capital per worker which occurred from 1897 to 1930, we might have had an even more rapid increase in productivity or output per person than we have had.

In other words, there is no magic to this 2-percent figure.

Maybe it could have been 3 or 4 percent if we could have had a more rapid rate of capital formation in the last 25 years.

The third point I want to make there is more short run in character. If our economy is going to generate somewhere around 25 or 30 billions of savings, then from the short run point of view of sustaining a high level of business activity and employment it is important that capital formation be maintained at a corresponding rate, if business activity is not to decline below what would be considered socially and politically reasonable.

Mr. CURTIS. Well, now, if we just took the one estimate or base of capital per worker and we assume that we are going to be absorbing in our economy each year about a million new workers—I think that is one of the estimates—on that basis, and take the figure of $11,000 of investment needed per worker, on that basis at any rate we would need about $11 billion a year for new capital formation.

I wonder if the other base of capital per dollar output can be reduced to an estimate of need for new capital.

I know those who advocate that recognition that there is a need for capital. They apparently though feel it is not as great a need as the figures based upon capital per worker, but I don't quite understand how they would make estimates to arrive at a figure of how much new capital would be needed each year.

Can either of you gentlemen help me on that?

Mr. McCracken. In the paper which I submitted some time ago—it is on page 144 of the Green Book—there is a table which presents some very rough figures on the relationship between gross national product and the stock of reproducible wealth.

I think one might figure somewhat the same way.

Let's assume that gross national product over the long run will rise at the rate of somewhere around 3 to 4 percent per year, to take cognizance of the growth in the labor force and improving productivity of the work force.

That is a growth of 12 to 15 billion dollars per year.

The ratio in 1955 is roughly $2 of wealth per dollar of gross national product, so an increase of $12 to $15 billions in our rate of output would imply that there ought to be a parallel increase in our stock of wealth somewhere around $25 billions.

Mr. Curtis. I was very interested in those tables because I note that beginning about 1936 where your ratio is 3 plus to 1, 1940, it goes to 3 minus to 1, 1949, 2½ roughly, and then 1955, 2, although the preceding years, going back to 1900, they all vary around 3, or 3 plus, etc.

Maybe that is a signficant thing. Maybe that is what these people are talking about when they say that the ratio of capital needed per dollar of output is an important thing to be thinking about, because if capital is more efficient—I don't care how you put it, or if the worker is able to produce more, the net point is if it is true we do need less capital in order to maintain the GNP, or the rate of 2 percent increase per year of GNP, so do you think there is any significance in that decline in the ratio from 1936 to 1955?

Mr. McCracken. Yes. In the first place I would want to make the obvious point that data on the stock of reproducible wealth have to be accepted with a substantial tolerance for possible inaccuracies.

It is a difficult thing to measure and the basic data are not too accurate. Nevertheless I think the conclusion which you stated is still correct, that the amount of capital per dollar of output has apparently been declining over say the last half century.

Now even if that is the case, and if we are to have a continued growth of $12 to $15 billion per year in our gross national product, which apparently is essential to maintain full employment, then there is going to have to be some growth in wealth, capital.

Now apparently 50 years ago it would have had to have been in the neighborhood of say, $35 to $50 billion to sustain the present rate of growth.

Now with a lower ratio, perhaps $20 to $25 billion or something like that will do the trick.

The second point which I want to make is that I would not accept as an immutable law that GNP or productivity ought to grow at the rate of 2 percent.

If our society is willing to save more, and have a higher rate of capital formation, maybe we can boost that 2 percent to 3 percent, or

4 percent. We want capital to be as productive as possible. Given the amount of capital formation which is consistent with our savings habits, then we want just as rapid a rate of increase in GNP as we can have, more than 2 or 3 percent if possible.

Mr. CURTIS. Getting back to your table and your comments about wealth, I presume the wealth that you refer to is a private wealth.

Mr. McCRACKEN. Yes.

Mr. CURTIS. Could it be that this plan has another factor in it, public wealth which is actually being used as a capital outlay to producing GNP.

For example, take St. Louis, Mo. The largest industrial plant we have there is Government-owned. It is used to produce ammunition. It produced all the ammunition for the Korean war for small arms. That is a tremendous plant.

The GNP would be reflected by the products coming out of there, but the capital investment would not be reflected in your figure of wealth.

I wonder if the amount of Government wealth that has been thrown in to our economy might not account for this seeming decline in capital per dollar output?

Mr. McCRACKEN. I think I may have spoken too hastily.

My impression, though I would want to check these figures is that they include total reproducible wealth, both public and private.

Mr. CURTIS. I might say I have in front of me, the book, Facts and Figures on Government Finance of the Tax Foundation.

It is the edition of 1952–53, having brought this particular table up to date.

In 1948 they have private wealth of $617 billion which conforms pretty well to your figure of $645 billion, in 1948.

I brought this to the attention of the other panelists: the interesting thing to me is the ratio between public and private wealth. In 1929 that ratio was 9 to 1, private to public, and in 1948, the last figures actually brought up, but you can project them through these tables to 1952, it has declined to less than 5 to 1.

I am not sure of the data upon which all of this is based, but I do think that any decrease in ratio like that is highly significant, and perhaps that is a factor that is the real cause for this seeming decline of capital per dollar output, because most of the estimates I have seen on that capital have referred to private wealth as opposed to Government.

Of course, if we have been building plants owned by Government, it is not just ammunition—as I illustrated to one panel before, we have coffee-roasting plants.

That is considerable outlay. That kind of thing has gotten into our economics. It becomes very important to weight that factor in there because then your basic figure, capital per worker, sounds like it might be a more accurate base upon which to project the needs for new capital.

Would you care to comment on those observations?

Mr. BURGESS. I think I could provide an answer, Mr. Curtis.

Either method, that is, a projection of capital required to produce a given output or a projection of capital required to employ a given number of workers, would provide a basis for forecasting future capital needs. The two results should not differ too greatly. Using the

ratio of capital to output, one might very well project some further increase in the efficiency of the use of capital.

Your own joint committee staff has recently made and published some projections with respect to 1965 on the basis of which output would be increased some one-third over current levels by 1965.

If real output is to be increased to that degree, we shall need from one-fourth to one-third more total capital in use by 1965 than now, even after allowing for some further rise in the productivity of capital.

We must consider that over that period we shall have to replace capital assets as they wear out, as well as add to the net supply in use.

Mr. CURTIS. Thank you for that.

Now I have one other question, and that is on the kind of capital to be raised.

I notice in both papers, but in your presentation, Mr. Burgess, here this morning, you refer to the amount of new money raised through equity—through issuing common stock.

What is that ratio?

As near as I can figure, although that ratio seems low to me in relation to borrowed money, and plowed back earnings, etc., that ratio of from 1939 to 1954—does that really vary much from the ratio, say, in the World War I period, from 1900 to 1910?

Have you ever seen any table to show the ratio between equity capital as opposed to borrowed capital, let's say, for finance or capital outlay?

I don't know. I am ignorant on the subject.

Mr. BUGRESS. Yes. I have seen such data and they reflect a relative decline in business financing through the use of equity capital.

Mr. CURTIS. That is the important thing, isn't it, whether the ratio has declined, because if it were a similar ratio of equity or borrowed, it would be an interesting observation.

Mr. BURGESS. In the postwar period, there has been a definite trend toward financing by borrowing as distinguished from financing by issuing stock.

Mr. CURTIS. I wanted to get that in the record. I would like to get some data on that because the data I have seen does not really indicate too much that there has been that decline.

Now then, in this discussion of how our tax structure has varied on the kind of capital that business can get, I would like to go through this little syllogism for your comments.

The main comment here was the individual with money to invest seeks lower yields through tax-exempt security, and so forth, but here is the thing that I have observed: that the investing public, which one of your papers points out is largely in your higher income bracket groups, is in a position where the dollars they have are investment dollars and not consumer dollars.

In other words, they don't have to get the dollars for consumption, and they prefer, due to the tax structure I suggest, to let their stock increase in value through the development of the corporation rather than to gain anything through dividends.

There are two reasons: One very obvious reason is that capital gain on the increased value of an equity share is only subject to 25 percent tax, and that is a considerable saving for this upper-income group.

Coupled with it also is the possibility that they may hold on and pass it on to the next generation.

Conceivably they could even escape any tax. That is one thing.

The other thing is this: that kind of shareholder is also perfectly happy, and in fact would encourage a corporation to finance its expansion through retained earnings, or through bank borrowings, especially through bank borrowings and bonds because the interest paid for that kind of investment capital is not even subject to 52 corporate tax; so there has been a tremendous incentive I suggest for the stockholding group, those who have got the equity, to have this expansion occur through bank borrowings and bond issues.

They themselves do not want to have the corporation finance its operation through new equity issues.

In other words, I wonder if the reason there has been a drying up of equity capital is not so much from the fact that the public would not demand it and would not buy the issues if they were issued, but rather from the corporations and those who control them not wanting to do it for reasons of taxation. Then I am going to complete this syllogism by suggesting that in my opinion that is so, that the demand for equity security is considerably beyond the supply and I suggest that that lies at the base of this stock market increase, because, not that the values might not be there, but there is this great demand for equity issues and there is a limited supply. Furthermore, the people who can best afford to buy the equity issues, are these very people who can think in terms of investment as opposed to consumption.

The investor can successfully compete against the small person who might want to get a few shares of stock for the price that he will pay for that stock solely because of the tax structure.

The investor can afford to not get any dividends, or get very slight dividends, because he is interested in his capital gains, while the lower income groups, and in which I might state I would be included from that angle, we try to get a few shares of stock and we have to think about what dividends we are going to get.

I wonder if you would comment and pick holes in those observations?

Mr. BURGESS. I should be glad to comment on parts of it.

First, in my opinion not all upper bracket investors are interested solely in capital appreciation. Many are interested in income as well and in the security of their investments. Even those who are seeking primarily capital appreciation are interested also in protecting the principal of their investment. Under our tax laws, a levy is made on capital gains, whereas the tax benefit from losses is severely limited. Thus, in a sense, it is a one-way proposition:

Investors must pay tax on the total of their net capital gains, but they are not permitted to take the entire net capital loss as a deduction—only a very small part of it, generally.

Mr. CURTIS. Even our big fiduciaries like colleges, universities, are now investing more heavily in equity issues, if they can get them, because the security on one of your blue chip stocks, the security of that investment is not very precarious.

Even our investment laws in our States as far as investment trusts, and so forth, have been modified by laws to permit that kind of investment, on the grounds that it is now well recognized as secure.

Mr. BURGESS. Many of those institutions are exempt from taxes you know.

Mr. CURTIS. I appreciate that. I am commenting solely on the aspect of safeness. I did not mean to bring it in from any other angle. I am solely addressing my remarks to your comment, that you thought that security was one of the motivating factors in the portfolios of these investing groups, and I was simply suggesting as far as blue chip stocks are concerned, I don't think that that, in my own judgment, has very little bearing on it.

Of course as far as the need for consuming dollars, the investing group does have some need for that, but they have, even with this business of allowing their equity to increase in value, they can always sell at times and do sell at times to get capital for consumption, because they only pay at a 25-percent rate, when necessary to realize that particular gain.

In my judgment this is a very fundamental thing and I think that our tax laws illustrate the 25-percent rate, the 52-percent rate, and the graduated rates are the answer to this very problem of why equity capital has declined, and if it is wrong I certainly want the economists and those who study these things to point out to me at any rate why that is not a fair analysis of the situation.

Mr. MCCRACKEN. I have 2 or 3 comments on that.

In the first place, one of the things which I think surprises anyone who looks into the statistics is the relatively small decline in the percentage of national income being saved, or the incidence of capital formation, over this period where the share of national income absorbed by taxes has enlarged so greatly.

The figures which I quoted there show that if one were to project the trend from say about 1900 to 1930, on into this postwar period, the present savings rate is a little below what that past experience extended on to the postwar period would imply but it is not very much below.

Moreover, there is not any question but what there has been a dual shift along the lines that you have talked about or mentioned.

In the first place, a shift so far as financing is concerned toward greater uses of debt in the capital structure than equity. I might just quote 1 or 2 figures which I think are rather interesting in that connection.

If one takes the postwar period for all nonfinancial corporations, permanent investment from 1945 to 1952 increased 138 billions, of which an increase in long-term debt accounted for 40 billions, or 29 percent.

On the other hand, at the beginning of that period debt accounted for only 20 percent of the capital structure.

In other words, a disproportionately large part of the new capital was coming in the form of debt.

There has been, at least in the last 2 or 3 years, a converse shift so far as investors are concerned toward equity so you have corporations in effect going in one direction, the investing public in the other, and of course the circumstantial evidence is what has been happening to prices of stocks in the market.

That may be explained in terms of the institutional demand, which you were mentioning, colleges, universities, and pension funds which apparently are a factor.

On the other hand, it is interesting that even in this postwar period wherein substantial incentive for debt financing did exist, debt accounted for only 29 percent of the new capital.

That is, equity, either retained earnings or new equity capital coming in, accounted for the other 71 percent.

Another point I would like to make is that theoritically, so long as some substantial part of the new capital requirements must be equity, a high corporate tax does eliminate certain capital expenditures which would otherwise, without the tax, be desirable, because the cost of money is only partially deductible, and of course the tax applies fully against whatever expected rate of return is involved in the project.

I think myself that a conclusion to be drawn is that a differentially low capital gains tax is an important part of the explanation for this mystery, as to why, with this enormous increase in our tax structure, we still have apparently a very high rate of capital formation. Productivity according to a recent release of the BLS is rising at roughly 3 percent per year, which does not suggest any great impairment over the prior period.

That is why I made this comment at the end of my statement, that I think certain loopholes of that sort, if you want to call them that, may be useful if they encourage the kind of tax avoidance which has a socially constructive end result.

Mr. Curtis. Thank you.

Thank you, Mr. Chairman.

Senator Douglas will interrogate.

Senator Douglas. The first point I would like to take up is the alleged marked decrease in the proportion which stock issues form of total issues of stocks and bonds, which I understand Mr. Burgess stated.

This same issue arose in the stock market hearings. Secretary Humphrey made the same statement and I challenged it at the time.

He was using figures prepared by the Treasury Department.

I was using figures prepared by the Department of Commerce. We had a rather lengthy exchange of correspondence, and we finally largely although not wholly reconciled our differences by getting a third set of figures, which we both agreed were better than the figures which either of us had originally advanced, namely, the figures compiled by the Securities and Exchange Commission.

Those figures were finally published in the printed staff report on factors affecting the stock market and appear at page 67, and if we have an extra copy, I would like to send it down to Mr. Burgess.

This morning while the discussion has been going on, we had two of our associates up here checking the figures and this is our result: That if you take the period from 1921 to 1927, omitting the extraordinary stock market years of 1928 and 1929, there were $6,750 million in stock issues out of total issues of $29,400 million bonds and stock issues, and therefore stock issues formed approximately 23 percent of the total.

For the years 1946 to 1954, there were $15,830 million stock issues out of a total of $69,704 million bonds and stock issues.

This came to approximately 22 percent, so that if we were to confine our attention to the period 1921–27, contrasted with 1946–54 there was no appreciable decrease in the proportion of equity financing despite

the fact that the corporate tax was I believe in the twenties only 12½ percent and in the postwar period around 50 percent.

If you put in 1928–29, the picture is changed somewhat, as those were high years, and the percentages—if you take the years 1921–29, the total stock issue was $14,500 million out of the total of $44,200 million in stocks and bonds, which meant that in the 2 years 1928 and 1929, almost $8 billion in stocks were issued.

This raises the percentage to 32 percent.

Aside, therefore, from the 2 years, 1928–29, which were a special case because of the terrific speculation going on in those years, it would not seem to me that the evidence was at all conclusive that there had been any significant decline in equity financing in recent times because of the high corporate tax rates, and I hope that these figures which now seem to be largely agreed upon both by the Treasury, by the Department of Commerce, and at least by my office, may now, if correct, be accepted.

These figures should cause us to think of the effect of the corporate tax in a somewhat different way from what has been customary.

Mr. BURGESS. Senator, may I ask whether the data shown in table 2 on page 67, which you referred to me, include issues for retirement of securities?

That is, for refunding?

My impression from the magnitude of the total, is that it does include refunding issues whereas in my paper I referred only to net new capital. I think it is the new capital that should have our attention, rather than the total, including refunding issues, and my data show that, considering only new capital additions from external sources, by far the greater proportion was raised by borrowing as distinguished from equity issues over the period 1939–54—the ratio was 100 to 18 for increase in corporate debt to net capital stock issues.

Senator DOUGLAS. I think it is very hard to draw conclusions on the period 1921–29, because there were so many refundings, not only as between types of common stock, but as between bonds and stock, stock and bonds, and so forth, so that it is pretty hard to tell what the net effect would be for the 1920's.

All I can say is that the figures which we have for the period postwar are about as close to the figures for 1921–29 as we can get them.

Mr. BURGESS. However, we are considering here the method of raising new capital.

New capital would exclude issues for paying off issues retired in my opinion.

Senator DOUGLAS. It has always been a great difficulty to eliminate refundings.

Mr. McCracken?

Mr. MCCRACKEN. One of the questions of course is why this issue is important.

Now the interest in it may be the proper concern on the part of people responsible for corporate financial policy, that the tax structure is pushing corporations dangerously far into a capital structure which is overloaded with debt.

Senator DOUGLAS. What I was questioning is whether this assumption is really true. We have had a lot of talk that it is true, but when I analyzed the actual figures it did not seem to me to be true. I grant

the Department of Commerce figures somewhat exaggerated the point of view to which I held but similarly the Treasury figures exaggerated Secretary Humphrey's position very much.

Mr. BURGESS. I think if you exclude the refunding issues there is no question of the truth of my statement to the effect that there has been a pronounced trend toward debt financing and away from equity financing in the postwar period.

Mr. McCRACKEN. May I make one more comment?

Senator DOUGLAS. Certainly.

Mr. McCRACKEN. The only figures which I used in the paper that I submitted for this green book were the figures, the compilations of the statistics from the Bureau of Internal Revenue.

They do show that the percentage of new capital in this postwar period of course was somewhat—raised by debt, was somewhat higher than the debt in the existing capital structure.

My own feeling is that even with the Treasury figures, it is pretty hard to draw the conclusion that there has been a dangerous movement in the direction of overloading corporations with debt.

After all, the amount of debt in the capital structure in 1945 at the end of the war on any logical basis would be expected to be abnormally low; and, consequently, raising that percentage, from 20 to 24 percent in the postwar period, could not in my judgment be considered dangerous.

I think the real significance of this issue here, and it is one which economists at least have given insufficient attention to, is that so long as any substantial part of new capital requirements must be raised by nondebt sources, then a substantial tax on corporate income does eliminate the justification for otherwise financially attractive projects in the capital budget. It works in the direction of reducing capital formation.

I think that is of more important significance than the other.

Senator DOUGLAS. I think that point is well taken, but the point that I would like to make is that I believe you will find, and I believe the correspondence will show that the Treasury agreed to the figures which were finally published; is that correct?

At least I am informed we did get agreement on the final table from Treasury and while we did not require them to make an open confession of error, nevertheless that amounted to a statement that their previous figures had minimized the amount of capital formation through the sale of stocks in the postwar period, and that therefore, if you are not worried on the basis of the Treasury figures, you should be still less worried on the basis of the SEC figures, unless it is this point that Mr. Burgess has raised.

Mr. McCRACKEN. That point is not my main concern. That was not the point I was trying to make a moment ago. The table which you both agreed on undoubtedly showed that of the total new capital requirements, somewhere around, I should judge, 75 percent was equity; was it not?

Senator DOUGLAS. That is right.

Mr. McCRACKEN. Substantially.

Senator DOUGLAS. 75 percent.

Mr. McCRACKEN. The point that I was making is that——

Senator DOUGLAS. On capital obtained from outside, about 75 percent was from bonds.

Mr. McCRACKEN. 75 percent was through bonds?

Senator DOUGLAS. Yes.

Mr. McCRACKEN. You mean for total business?

That must not include retained earnings. That could not include retained earnings.

Senator DOUGLAS. What you are saying is that if stock issues and retained earnings are combined—retained earnings being equities—there would be 75 percent in equity financing and 25 percent from bonds, even though as between only bonds and stocks, the situation is almost completely reversed, since about 50 percent of earnings are retained and reinstated; isn't that what you are saying?

Mr. McCRACKEN. That is my point and the conclusion that I was drawing here was that so long as a very substantial proportion, over half, certainly, of new capital requirements must be met by nondebt sources, either retained earnings or new issues of stock in the market, then it does mean that theoretically certain kind of capital formation projects which would be financially profitable on the basis of no corporate income taxes will no longer be financially justified in an area when corporate profit taxes take roughly half of income.

Senator DOUGLAS. Now, may I pass to the second point? When I was a practicing economist I laid great stress on the importance of capital in increasing productivity and in the statistical studies which I made it seemed to me it was indicated that if capital were held constant and labor increased by 3 percent, an increase in productivity resulted. I eliminated technological changes. Capital indeed seemed to increase appreciably faster than product and an increase of 3 percent in capital appeared to cause an increase of 1 percent in product. It seemed to me, then, that in order to increase average productivity per worker capital had to increase at an appreciably faster rate than the increase in numbers employed, and the logical conclusion to be drawn from that is, of course, that there should be a rapid increase in capital in order to promote an increase in productivity per worker, and in the standard of life. That is true, I believe; I am a little puzzled however, in this connection with the recent developments in which, apparently, capital has not been increasing more rapidly than productivity but possibly less rapidly. I am also puzzled by the fact that there has been an extraordinary increase in productivity which seems to belie all the prophets of doom, despite the rate of capital formation to productivity, despite the corporation tax, and despite the high brackets. The volume of savings now seems to be higher and the increase in productivity perhaps proportionately still higher so that the country hasn't gone to the dogs. I wonder, therefore, if we are not confronted with Herbert Spencer's idea of a tragedy; namely, a beautiful theory in conflict with cold, hard facts, my own theory included.

Mr. McCRACKEN. Let me defend your theory. I think the kind of work which you were alluding to here, developing the coefficients of capital and labor, still lead to the correct conclusion. Now, if the conclusion is that there must be a rise in capital per worker in order to have any increase in productivity then obviously, the conclusion does not follow, because the empirical evidence shows that that hasn't occurred in recent years.

On the other hand, it seems to me the proper conclusion to draw is that there is a relationship, abstracting from other things, between the amount of capital per worker and the productivity of the work force, and that had capital formation been higher so that the amount of capital per worker had been growing, the rate of improvement in productivity would have been even higher than the fairly impressive rate which did occur.

Mr. BURGESS. Senator Douglas, I think we should make it clear whether we are speaking of the ratio of capital to unit of output, or capital per worker.

My impression is that capital per worker has been increasing and still is increasing. However, the capital required for a unit of output has been declining, owing to the greater efficiency in the use of capital.

However, such a tremendous increase in output is required over the next decade that despite the increased efficiency in the use of capital we shall need tremendous additions to our net supply.

Senator DOUGLAS. There is another point that I would like to touch on. Those who take the general point of view that Mr. Burgess has taken—and I am not criticizing the honesty of his point of view at all—will generally concentrate their attention as I see it, upon the high rate of progression, that is the high progressive rates in the income tax, and upon the 52-percent corporate tax.

It is true that those rates tend to be somewhat frightening when one thinks of an incremental marginal rate of 71 percent which is added to an average rate of 20 percent for the upper income brackets earning over $200,000, and when added to a basic rate of 20 percent comes to a total marginal rate of 91 percent. A married family in receipt of $500,000, pays an average tax apparently of 80 percent of income.

Now, if taxes take as much income as that, naturally savings decrease and of course in the process luxuries decrease too, but savings do decrease. I think two things tend to be forgotten, however one of you alluded, I forget which one of you, to one of them.

First, is the fact that the income and corporate taxes are, after all, not all of the total system of taxation, and as was pointed out yesterday, the excise taxes, which are still a respectable fraction of Federal taxes, coming to between 9 and 10 billions per year, are regressive.

They are, actually regressive, because the wealthy man does not smoke a hundred times as many cigarettes as the poor man and the poor man, therefore, pays a much higher percent of his income in excise taxes than does the rich man. Nor does reflection on the income tax alone take account of State and local taxes; the sales taxes are of course regressive. The gasoline tax is probably regressive, after a given point, for those who have cars.

The property taxes, I think, are much more regressive than even the Michigan study seems to indicate, due to the general tendency to underassess industrial and commercial properties and wealthy residences as compared to homes of the workingman.

The result is that if one looks at the tax structure as a whole, one comes close to Dr. Murgrave's estimates of the incidence of taxation, which you probably saw in his paper. Instead of a U-shape curve of 5 years ago his studies now show a proportional level for

a time and then an increase in progression. What I am trying to say is that we now have apparent proportionality in the general system of taxation up to $10,000, that is rough proportionality, and progression only after the $10,000 point has been reached.

Secondly, though this point may be partially included in the first point, the erosion of the income tax under preferential treatment has produced a large number of loopholes by which those in the upper bracket income groups avoid taxation.

I need only mention a few of these so-called loopholes: The split-income provision, which almost halves the tax in the upper income groups; the capital-gains tax, whereby what would normally be regarded as income is frequently regarded as a capital gain; the dividend credit, which I think is a monstrous provision in which, for the first time, there is a provision that 4 percent or a given percentage of dividends is deducted not from taxable income, but is deducted directly from actual taxes paid. So far as I know, this is almost a unique principle in taxation.

There is also the depletion allowance, about which we will hear more, and various other provisions I could touch on.

I am just going to throw in one more point: that is the fact that although wages and salaries have their basic rate taxed at the source, there is no such withholding tax on dividends and interest and it is apparently true that even if an allowance is made for exempt interest, the total amount of such income paid out by corporations and private parties exceeds the amount reported by individuals. This indicates that there is some forgetfulness, to put it mildly, in reporting, so that if we take all these factors into consideration, the net effect is not to give us as much progression as those who, looking at the income tax or the corporation tax alone, might conclude.

Now, I believe one of you—I don't know which one—said that this might be a good thing because in spite of the progression the loopholes were sufficient to siphon off large amounts to those in the upper income groups so that they could invest it after all, although it probably also increases their expenses at Las Vegas, Palm Springs, Miami, and other places.

That is the point I now want to throw out for discussion, and if either of you have any comments on that, I will appreciate them.

Mr. BURGESS. I should like to comment on that, if I may, Senator Douglas. I think what you say is true, that there are certain modifying factors. It is a question largely of degree, and the effect of many of them cannot be measured.

I think the fact that consideration of the total tax system modifies the degree of progression in the brackets up to $10,000 is probably the least important of the factors you mentioned, because the investors we must rely upon to provide the bulk of the new capital are in brackets above the $10,000 level, where the progression is retained and intensified.

Those investors are benefited some by these other provisions, sometimes referred to as loopholes.

Senator DOUGLAS. I am very glad to have you say that, Mr. Burgess, because I had another controversy with Secretary Humphrey, who maintained that the distribution of ownership in American corporations was very broadly based and that the low-income people

owned the major share of stocks in American corporations. This seemed to me to be an extraordinary statement. I am very glad now to have Mr. Butters' paper which indicates that about 75 percent of marketable corporate securities are owned by those family units with wealth of about a quarter of a million dollars or more. I am very glad to have your statement in this respect, and while I don't wish to carry this to a running feud with the Secretary, I am going to ask for extra sheets of your testimony so that I may send them to Mr. Humphrey with my compliments.

Mr. BURGESS. Senator Douglas, the two statements may be reconciled possibly. There are so many, many small investors that it may well be true that a majority of the total have incomes under $10,000.

Senator DOUGLAS. I was speaking of the proportion of their holdings, and you agree it is a relatively small proportion which the small investors hold?

Mr. BURGESS. Yes, sir.

Senator DOUGLAS. Go ahead. I didn't mean to interrupt you but I foresaw a chance to correct Mr. Humphrey's economic thinking and I can't let that pass by.

Mr. BURGESS. I was saying that the investors in the upper brackets are influenced by these modifying factors, but the rates are so severe, and the progression so steep, that despite these modifying factors, there remains a serious deterrent to investment on the part of those groups, in my opinion.

Senator DOUGLAS. I am just making this comment. What we seem to do is, under the belief in the principle of progession in taxation which we associate with either taxation according to ability to pay, or equal sacrifice, or least sacrifice, whatever the theoretical basis for it is, we pass an inheritance tax; then ways are devised to avoid this inheritance tax. We get the legitimazation of gifts prior to death, so when the inheritance appears it is relatively insignificant and the tax is small. Thus the inheritance tax has withered until it is a very minor piece of fruit upon the tax tree.

With belief in the progressive principle, we put in a progressive income tax, and then the pressure groups started to work on the public, and on the House Ways and Means Committee.

Then, on the corresponding committee, the Finance Committee, of the Senate, and one by one the many exceptions appeared, so that now we have a tax system very different from what we thought we were getting in the days when we passed, respectively, an estate tax and an income tax.

Those of us who believe in the principle of principle perhaps can say the moral is "we can't win." Some of you may say, "Well, the change has been for the better. It has mitigated a system which otherwise would largely have stopped investment."

There is a field for discussion but I do want to say if you view the tax system as a whole, you will find it is not so tough on people with high incomes as they sometimes like to claim.

Mr. MILLS. You realize, I am sure, that the purpose of this study is to find, if possible, some general economic principles which we can recommend as guides for tax policy for economic growth.

I gather from both you gentlemen this morning that you are not satisfied with existing tax policy insofar as the proper amount and

the proper character of investment capital is concerned. That is true, is it not?

Mr. BURGESS. That is correct, so far as I am concerned.

Mr. MILLS. Do you agree, Mr. McCracken?

Mr. McCRACKEN. Yes, sir.

Mr. MILLS. In other words, the effort made in connection with the modifications of the code, now known as the Internal Revenue Code of 1954, were not sufficient to place in proper balance, in your opinion, this element of investment capital.

Mr. BURGESS. I should like to qualify my answer to that.

Mr. MILLS. I want you to tell me what your position is with respect to those changes.

Mr. BURGESS. In my opinion, the direction of those changes was all to the good. However, they dealt with the fringes of the problem and not the core of it, which I consider to be rates and degree of progression.

The 1954 code contained many, many special provisions, and so-called gadgets, but didn't attack the real problem, namely, rates and progression.

Mr. MILLS. Mr. Burgess, you didn't write my speech on the floor when I spoke to the bill but I see that you have reached a point in conclusion that I reached: The basic difficulty so far as investment capital is concerned, is always the rate.

Mr. BURGESS. I believe so.

Mr. MILLS. Mr. McCracken, will you comment on your position with respect to my question?

Mr. McCRACKEN. Yes.

The weight of our discussion here, and whatever empirical evidence one can marshal on this question clearly I think, leads to the conclusion that capital formation is somewhat lower at the present time relative to our national income than one would expect, had the experience in the lower tax era 25 or 30 years ago, prevailed at the present time.

Now, that suggests that one of the basic troubles with the tax situation, and the disincentive effect of taxation on capital formation, is that the total tax structure is too high.

Whether anything can be done about that depends importantly on whether the realities of the world situation, permit any significant reduction in the budget.

Mr. MILLS. Mr. McCracken, pardon the interruption, but our purpose here is to try if we can, as I said, to find certain broad principles that must exist in tax policy if we are to have proper economic growth and stability over a long-range period of time.

That element must be given consideration, must it not, in connection with these other factors that determine what rate of tax we are to have in any given period of time.

Mr. McCRACKEN. By rate of tax, do you mean the rate structure?

Mr. MILLS. I mean the rate structure, and I am referring to our observation of a moment ago, when you introduced other factors that might determine, in addition to the economic conditions, the rate structure within the tax policy that we had.

Mr. McCRACKEN. Yes, well.

Mr. MILLS. My observation is that too often we overlook this other factor we are considering, the economic factor.

Mr. McCRACKEN. This was merely a prefatory statement by way of saying that the most essential and fundamental tax reform ought

to be a significant reduction in taxes. This may simply be a choice that isn't available in the real world and therefore the question is where do we go from here in the way of developing a tax structure as distinct from the total tax take, which at least is going to minimize the inpediment on economic growth and expansion.

In the statement which I read, I outlined 3 or 4 modifications that it seems to me will be desirable by 1956.

Mr. MILLS. And Mr. McCracken in your observations now you are laying aside the question of proper economic growth and you are thinking in terms of tax policy affecting investments, what elements of present tax policy do affect investment, are you not?

Mr. McCRACKEN. Yes.

Mr. MILLS. Would you spell those out to some greater extent than you did? In other words, what are the specific features of our present tax system which have a particular bearing on investment?

Mr. McCRACKEN. Well, taxes are going to affect investment in one or both of two ways: Either they are going to result in a decline in savings, or they are going to reduce the incentive on the part of companies to borrow savings and spend them on machinery and equipment and new plants and that sort of thing. In other words, either they reduce the possibility of financing these projects or they reduce the incentive of businesses to try to finance them.

Mr. MILLS. Would it bother you if I interrupted you again?

Mr. McCRACKEN. No, sir.

Mr. MILLS. I want to understand your point of view completely. I used to disagree with those who said that the rate of tax applicable to corporate earnings was deleterious from the point of view of the consumer; that regardless of what rate of tax Congress imposed, that rate would be reflected as an element of cost in determining the price of the commodity.

Therefore, the tax placed upon corporate business enterprises would be passed on as a part of price to consumers and the consumer would, in the end, be paying that.

Those who expressed that viewpoint over the years always used that viewpoint to justify reducing corporate rates.

Now, is it factual that within the past several years, say, since the close of World War II, it has been possible for corporate businesses to pass on as a part of price these rates of taxes that we have levied, even including in many instances the excess-profits tax?

Mr. McCRACKEN. Well, it seems to me we start out with the basic and self-evident point that corporations as such do not pay taxes. The tax as such rests ultimately on people.

Mr. MILLS. Under the Internal Revenue Code, though, a corporation is an individual for tax purposes.

Mr. McCRACKEN. Possibly so.

But nevertheless, a corporation is simply an association of people. My point is this: That the corporation income tax ultimately is going to have to be paid, either by the stockholders, because the tax is not passed on, or it is going to have to be paid by the employees because it is reflected in lower-wage rates, or it is going to be paid by customers in the form of higher prices. It seems to me one or the other or some combination of those three groups will have to bear the corporate tax.

One of the reasons why I think it is not wise for the corporate tax to go certainly any beyond 50 percent—I could put the figure considerably lower than that—is precisely that there is so much uncertainty as to who does pay the tax.

There is this question as to whether a higher corporate income tax is reflected in prices or not. If it is it is a sales tax, and becomes regressive as Senator Douglas pointed out. If it is passed backward to employees, it is a payroll tax.

If it comes at the expense of stockholders, then it has an uneven impact, because not all stockholders are in the same income range. While they tend to be in the high-income range, there are substantial differences.

That is why I would feel that one of the first modifications, if there is any elbow room for tax reduction, should be pulling the 52 percent rate back down, at least to 50 percent.

Mr. MILLS. Mr. McCracken, what I am attempting to discover is your thinking on the point: Whether or not the tax rate itself is deterrent to obtaining investment capital, if that tax effect is passed on as a part of the price to the consumer.

Mr. MCCRACKEN. It is then a deterrent to investment.

Mr. MILLS. Is it under those circumstances a deterrent to investment?

Mr. MCCRACKEN. Yes; it is. On the other hand, the evidence seems to me quite clear that it certainly is not entirely passed on.

Mr. MILLS. Isn't it a fact that, even with 52 percent corporate rate, that the larger corporations in the United States have filed statements indicating that they have been able to accumulate profits after taxes in excess of profits accumulated after taxes when the rate was only 40 percent?

Mr. MCCRACKEN. Well, I will accept those figures.

Mr. MILLS. Stimulating an increase in the values of stocks, stimulating an increase in the amount of the reserve, which such businesses may have for expansion, exploration, development of new gadgets for sale.

Mr. MCCRACKEN. I will accept the figures.

I don't know what the figures are but I am sure that is correct.

That might not be saying, however, anything more than that the period of high corporate income taxes has also coincided with the period when the national income and other factors have been growing substantially.

Nevertheless, corporate profits after taxes, as a percentage of national income, are lower than they were in 1929.

They are lower than they were in 1950.

Mr. MILLS. I didn't understand your statement there, that corporate profits after taxes are lower now.

Mr. MCCRACKEN. That as a percentage of national income they are lower than they were in 1929 and lower than they were in 1950.

I think quite frankly that it is very difficult to push beyond this conclusion, which is that nobody knows what the ultimate incidence of the corporate income tax is, and that one of the reasons for not moving too far in the direction of corporate income taxation is precisely this equity consideration that you do not know who is paying the tax. To say that either the stockholders or the customers pay the full tax is, I

think, an oversimplification. They probably both pay it to some extent.

Mr. MILLS. The payment of tax of any business must be a cost of operation, if that business is to succeed for long.

Mr. McCRACKEN. I think not necessarily.

Mr. MILLS. Do you think it is possible for a business to survive without being able to include taxes as an element of cost?

Mr. McCRACKEN. We are talking about corporate income taxes?

Mr. MILLS. Yes, sir.

Mr. McCRACKEN. All I am saying is that I think it is quite conceivable that some part and possibly some significant part of the corporate income tax is ultimately paid by the stockholder, and not fully reflected in the price of its product.

Mr. MILLS. You mean paid by the stockholder in reduction in dividend?

Mr. McCRACKEN. Reduction in dividend or reduction in retained earnings.

Mr. MILLS. We have discussed one phase of our tax system, namely, the rate, which may have a bearing on investment. What are some of the other features of our present tax system which have some bearing on investment?

Mr. McCRACKEN. I mentioned another feature which it seems to me is worth mentioning here, and that is that the change in the 1954 Revenue Act, in the direction providing more flexibility with respect to treatment of depreciation, is, I think, a step in the right direction.

I think it is a wholly desirable step.

Mr. MILLS. We are talking about those features in the present system that are deleterious rather than helpful, I thought.

Mr. McCRACKEN. Well, I don't want to belabor the point, but I rather get the impression that this depreciation provision is one of the more controversial measures about which there is not general agreement, and therefore, I do want to mention this. This may be one of the things about which there will be some suggestion for modification, or even moving back to the older and more inflexible procedure. I think that would be a move in the wrong direction.

Mr. MILLS. You are referring now specifically to the acceleration feature, accelerated depreciation?

Mr. McCRACKEN. Yes; the provision for alternative and more flexible provisions for depreciation.

I think also there are sound theoretical, logical reasons, for taking the change in the price level into account in depreciation charges, but that is getting into a much more controversial area, and although I personally would feel that that would be a move in the right direction, it is less important now than it would have been a few years ago because so much of our plant and equipment now is installed at the postwar price level.

Apart from that, the other point that I would make is that I think 1956 business conditions will be such as to make it desirable to consider something like a 3 to 4 billion dollar tax reduction. Perhaps that is simply alluding to the rate problem again, but I think it is worth mentioning.

Mr. MILLS. I don't want to go over this again, but since you raised this point, what economic factors do you see, or economic conditions arising in 1956, that may necessitate or justify a reduction in revenues of some 3 or 4 billion dollars?

Mr. McCracken. In the first place, we have had by now a sufficiently tight monetary and credit policy so that by next year the economy will need a little stimulus.

Mr. Mills. On the investment side or the consumption side?

Mr. McCracken. Primarily, on the investment side.

Well, including in the investment side, of course, residential construction.

Mr. Mills. Do you suggest a tax reduction because you anticipate a gap between total consumption in the United States and total capacity to produce that consumption?

Mr. McCracken. That is correct—a gap between total demand and productive capacity if we do not get a tax reduction.

I think that is a possibility.

Mr. Mills. Well, if you provide the 3 or 4 billion dollar reduction in revenues, emphasizing the investment character of the reduction, do you raise your consumption or do you tend to further raise your capacity to produce?

Mr. McCracken. Well, both occur.

That is to say, one way certainly of stimulating or insuring a sustained high level of capital outlays is to make sure that consumer expenditures and consumer demand are sufficiently high to be putting pressure on the existing productive capacity of industry. But a high level of capital formation is also essential for the full employment which makes possible a high level of consumer demand.

Mr. Mills. Mr. McCracken, the reason I am asking you the question is the difficulty I have in understanding how you use tax policy to stimulate consumption, if you do not give some tax relief to those of our population who use the most dollars of their tax relief for consumption purposes.

Mr. McCracken. Well, I don't see that that is inconsistent with what I just said. Suppose we reduce the corporate income tax by 2 percentage points, down to 50 percent, which would reduce corporate income taxes by roughly eight to nine hundred million.

Now, that eight to nine hundred million of tax relief is either going to go in the form of additional dividends—in which case it directly steps up disposal incomes—or it is going to go into retained earnings, which provides the financial means for a stepped-up rate of capital formation. And a high rate of capital formation is an essential condition of full employment.

Now, actually the major part of the total tax relief which it seems to me might be in order was a direct reduction in personal income taxes.

Mr. Mills. But you said in the middle and upper brackets; didn't you?

Mr. McCracken. No.

I said that I think the ends of good economic policy would be well served if an important part of that would be. The only point I wanted to make there was that I would not recommend a tax reduction, such that the whole of it was centered at the low-income level.

Mr. Mills. I notice you did not suggest that any part of the $800 million that might result from a reduction in corporate taxes would go into a reduction in the price level.

Now, if it would go into reduction of the price level, it might well have an effect upon increased consumption.

Mr. McCracken. That is right.

Mr. MILLS. Do you think none of it would go into reduction of price?

Mr. MCCRACKEN. I think it is quite possible that some of it would.

Mr. MILLS. An insignificant part?

Mr. MCCRACKEN. I don't know. I am sure it varies by industry. It might vary by companies.

Mr. MILLS. We have found that sometimes when we reduce excise taxes we do not affect the overall price of the commodity. That is the reason I raise that question.

Do you have any additional suggestions to make, Mr. Burgess, with respect to specific features of our tax system that have a particular bearing upon this question of investment?

Mr. BURGESS. The thought occurred to me during your discussion with Dr. McCracken, that we ought to distinguish between tax policy to promote long-term economic growth, and tax policy that might affect short-run stability of the economy.

Mr. MILLS. You are exactly right.

Mr. BURGESS. My remarks this morning were primarily directed toward long-term economic growth, and a tax structure to assure that and to achieve it. However, we will need to consider—there will be consideration, I perhaps should put it, of tax reduction over the coming 12-month period, in the interest of short-run economic stability.

I could comment upon that aspect if you wish. You asked me——

Mr. MILLS. Pardon me. I would prefer that you speak with respect to the specific features of tax law that have to do with long run effects upon investment.

Mr. BURGESS. That is what my paper deals with, and that is the subject in which I am most interested.

I have referred to the progressivity of the individual income tax and the high rates both of the individual income tax and the corporate tax as by far the most important deterrents to new capital investment.

Other features are of minor importance in my opinion. They would include depreciation. Although terms were liberalized in the 1954 code, I think we could go further to advantage. Also, I think some further liberalization of the capital-gains tax and the capital-loss provisions is in order.

Among the considerations of lesser importantance are the tax on intercorporate dividends and the penalty tax on consolidated returns; and most respectfully, I suggest further study of the prepayment of the corporate tax, in which you have interested yourself.

Mr. MILLS. Not in the prepayment.

Mr. BURGESS. No; the advance in tax payments.

Mr. MILLS. You remember mine was with respect to a payment within a certain time after the end of the taxable year, but not before the end of the taxable year.

Mr. BURGESS. I remember that.

Mr. MILLS. It was the Treasury's suggestion in connection with the modification in 1954.

Mr. BURGESS. I think we could study that to advantage. There are a few other tax obstacles but they are of relatively minor importance now in my opinion.

Mr. MILLS. Let me ask you then, do you consider that any of these features that you and Dr. McCracken have discussed have a differential impact with respect to types of capital outlays?

Mr. BURGESS. I am not sure I understand your question.

Are you inquiring whether each of these aspects has the same effect on investor attitude and capacity?

Mr. MILLS. On all types of capital outlay or whether there is a differential effect.

Mr. BURGESS. There is a very definite differential effect. Some of them affect the corporation, some affect the individual. Certain ones affect the capacity to invest, others affect the willingness, and some affect the timing of investment action. Generally, the effects are complex to some degree.

Mr. MILLS. None of the features you have discussed, I take it, except the level of rates on individuals is as important as the matter of the feature discussed by Professor McCracken, namely, the corporate rate itself.

Mr. BURGESS. The corporate rate itself is important, but not in my opinion as important as the individual-tax structure.

Mr. MILLS. Well, then, let me ask you this: Are these particular features that we are discussing as important as the level of taxes in relation to expenditures?

Mr. BURGESS. Generally speaking, we must raise enough revenue to balance our expenditures, with a certain leeway, depending upon economic conditions. My concern at this time is not so much with the total tax burden, about which we can do little while defense needs remain so great, as it is with the tax structure itself.

Mr. MILLS. That leads me to my next question: In attempting to develop these long-range principles, should we be concerned primarily with the level of taxes affecting investment, or with specific structural features of the tax laws?

Mr. BURGESS. In my opinion, a large part of the problem can be corrected and remedied without substantial loss of revenue.

Mr. MILLS. Without substantial loss of revenue?

Mr. BURGESS. Moreover, in my opinion, as our economy expands over the years, we shall have at our disposal additional revenues flowing to the Treasury which will afford opportunities for tax reduction.

Mr. MILLS. Mr. Burgess, during the course of our hearings so far we have had testimony, and particularly from Mr. Keezer, whom you perhaps know, to the effect that the Federal tax system has not unduly repressed economic growth.

I observed you this morning making a statement to the contrary. I wonder therefore if you could give us some objective evidence to verify your belief that there is a repressive effect upon economic growth at the present time, due to our tax system?

Mr. BURGESS. In the face of the phenomenal rise in output and consequent improvement in living conditions that have taken place over the last decade, it is difficult, of course, to provide persuasive evidence that we would now be still better off if the total tax levy by the Government had been less and if rates had been lower.

Nevertheless, I am convinced that that is true. It appears obvious to me that if our total governmental expenditures for defense and other purposes were not so high, and taxes were more moderate, more of our resources could be devoted to production of goods and services to improve the standard of living.

Mr. MILLS. Mr. McCracken, one of our panelists has pointed out, and Mr. Keezer again, that the present corporate tax has not signifi-

cantly impeded capital outlays by large companies, but probably has limited capital accumulations by small businesses.

Do you agree with that conclusion?

Mr. McCRACKEN. Yes, I think I would.

Mr. MILLS. What aspects of the corporate tax are responsible for this result?

Mr. McCRACKEN. Well, of course, again, perhaps the most important aspect of it is the sheer size of the share of corporate income taken in taxes.

If we assume that at least not all of the tax is passed on, and therefore retained earnings are somewhat lower as a result of the high corporate taxes, then it raises the question as to whether our tax policy thereby is penalizing the smaller corporation at the rapid-growth stage relative to its competitor, who has already more nearly arrived.

It is an interesting question, as to what the size of a company such as General Motors, or Ford, would be now had throughout their existence they had a 50 or 52 percent corporate tax structure.

It might be that some sort of differential provision could be made in favor of the small or new company, but I find it very difficult to think of any way which would be feasible to work it out.

Mr. MILLS. Actually this conclusion, then, if we are in agreement that such is the situation, would justify a greater differential for the benefit of the smaller companies than existing law now provides.

Is that your opinion?

Mr. McCRACKEN. Yes.

Mr. MILLS. If it could be done in line with your thinking of the revision that should be made on that point?

Mr. McCRACKEN. Yes.

Mr. MILLS. Would there be any further revision that you could think of?

Mr. McCRACKEN. In the corporate income tax?

Mr. MILLS. To accomplish leveling here, to prevent this conclusion that we have just discussed.

Mr. McCRACKEN. Well, in principle it seems to me this is highly desirable. The problem is how one goes about defining the units who are going to be eligible for differentially light tax treatment.

One might defend the view that the new companies ought to have differential treatment but then of course how do you define a new company. I suppose one way to do it might be to eliminate outright the first part of a company's earnings. But there are of course situations already where fundamentally one business unit is split up into several corporations for tax reasons, so I think in principle this is a wholly desirable thing, but it is difficult for me to think my way through as to just how to accomplish it.

Mr. MILLS. I wonder, Mr. McCracken, if you or Mr. Burgess, either one, have made studies that would advise us whether there has been the same general percentage of growth in small business that there has been in the larger businesses of the United States in the last 10 or 15 years?

Have either of you made any studies that would give us an answer?

Mr. BURGESS. I have seen such studies, Mr. Mills.

My impression from studies I have seen is that there has not been a great growth in concentration of industry in the last decade.

Mr. Mills. I do not mean that, but has there been the same percentage of growth enjoyed by smaller businesses, as compared to those that we define as larger businesses in the United States in that 10- or 15-year period?

Mr. Burgess. I am not sure data are available to answer that question directly.

I believe the annual number of new businesses started shows no decline in recent years.

There has actually been an increase in the number of new business incorporations for each of the last 3 years.

Mr. Mills. Has there been an increase in business failures?

Mr. Burgess. Some, but not substantially in relation to the number of businesses in existence, to the best of my knowledge.

Mr. Mills. Do you know what figures are available for failures of businesses?

Mr. Burgess. Such data are compiled and published.

Mr. Mills. You may have seen some of it. Approximately 11,000 businesses within the last 12 months, say?

Mr. Burgess. I just do not recollect.

Mr. Mills. I have seen some figures to that effect.

I wondered whether or not those are small businesses or the larger businesses.

Mr. Burgess. Generally speaking, the large majority of the failures are small businesses.

Mr. Mills. Would you think that that is attributable in any way to our present tax system?

Mr. Burgess. In part. I think many businesses fail through lack of adequate capital, and our tax system does make it difficult to raise capital, particularly for small businesses.

Mr. Mills. If we want long-range economic growth and stability we must, therefore, develop tax policy that will encourage new businesses and the growth of small businesses do you think?

Mr. Burgess. In my opinion that is absolutely correct.

Mr. Mills. That is one of the general principles we can address ourselves to in this subcommittee with some degree of merit?

Mr. Burgess. Yes, indeed, Mr. Mills.

Mr. Mills. Thank you, sir.

I do not desire to delay the panel longer here, although I have quite a number of further questions I want to ask.

Do you have a further question, Mr. Curtis?

Mr. Curtis. No.

Mr. Mills. Senator Douglas?

Senator Douglas. There is one bit of evidence I would like to introduce to bear out my statement that due to various provisions in the Internal Revenue Code, the actual amount of taxable net income of individuals is appreciably less than their gross individual income. I have before me the Report of Statistics of Income of the Internal Revenue Service for 1951, Part I, and there are summaries of material given there on page 80 and the pages following that I should like to have incorporated at this point in the record, if I may.

Mr. Mills. Without objection they will be introduced.

(The documents are as follows:)

TABLE 20.—*Distribution of taxable individual income tax returns with itemized deductions by adjusted gross income classes and by surtax net income brackets, 1951*

PART I—SINGLE PERSON AND MARRIED PERSONS FILING SEPARATE RETURNS

Adjusted gross income classes	Number of returns	Size of surtax net income										
		Not over $2,000	$2,000–$4,000	$4,000–$6,000	$6,000–$8,000	$8,000–$10,000	$10,000–$20,000	$20,000–$50,000	$50,000–$100,000	$100,000–$150,000	$150,000–$200,000	Over $200,000
$600, under $2,000	659,842	659,842	-	-	-	-	-	-	-	-	-	-
$2,000, under $4,000	1,255,146	1,020 287	234,859	-	-	-	-	-	-	-	-	-
$4,000, under $6,000	371,387	71,121	281,013	19,253	-	-	-	-	-	-	-	-
$6,000, under $8,000	80,652	[1] 3,083	19,468	56,571	(1)	-	-	-	-	-	-	-
$8,000, under $10,000	30,925	384	1,965	11,304	16,716	556	-	-	-	-	-	-
$10,000, under $12,000	17,858	91	283	1,324	7,749	8,127	234	-	-	-	-	-
$12,000, under $14,000	13,392	(1)	[1] 95	388	1,287	5,687	5,885	-	-	-	-	-
$14,000, under $20,000	24,982	(1)	[1] 93	151	460	1,675	22,589	-	-	-	-	-
$20,000, under $50,000	35,135	(1)	(1)	(1)	[1] 91	[1] 99	[1] 11,096	[1] 23,709	-	-	-	-
$50,000, under $100,000	7,939	-	-	1	1	3	16	2,699	5,219	-	-	-
$100,000, under $150,000	1,697	1	-	-	-	-	1	10	831	854	-	-
$150,000, under $200,000	610	-	-	1	-	-	-	2	18	331	258	-
$200,000 or more	954	-	-	-	-	-	-	2	3	24	217	708
Total returns with surtax net income	2,500,519	1,755,196	537,818	89,035	27,503	16,163	39,911	26,430	6,071	1,209	475	708

70325—56——9

PART II—MARRIED PERSONS FILING JOINT RETURNS

Adjusted gross income classes	Number of returns	Size of surtax net income									
		Not over $4,000	$4,000–$8,000	$8,000–$12,000	$12,000–$20,000	$20,000–$40,000	$40,000–$100,000	$100,000–$200,000	$200,000–$300,000	$300,000–$400,000	$400,000 or more
$600, under $4,000	2,248,291	2,248,291									
$4,000, under $8,000	4,187,354	3,823,542	363,812								
$8,000, under $12,000	480,716	66,249	390,424	24,043							
$12,000, under $20,000	285,606	3,008	37,265	156,911	88,422						
$20,000, under $40,000	216,061	203	527	2,891	89,057	123,383					
$40,000, under $100,000	89,405	[1] 12	54	77	268	27,828	61,154				
$100,000, under $200,000	13,088	3	1	2	6	46	4,215	8,815			
$200,000, under $300,000	2,123				1	4	22	955	1,141		
$300,000, under $400,000	657						1	25	356	275	
$400,000 or more	777					1	1	5	21	178	571
Total returns with surtax net income	7,524,078	6,141,320	792,083	183,924	177,754	151,262	65,393	9,800	1,518	453	571

NOTE.—Detail will not add to total because of omission of returns subject to sampling variation of more than 100 percent.

[1] Returns subject to sampling variation of more than 100 percent.

Source: Internal Revenue Service, Statistics of Income for 1951, pt. I.

Senator DOUGLAS. I would like to take first the single persons and married persons filing separate returns who had adjusted gross incomes from $100,000 to $150,000 and point out that in 1951 there were 1,697 of these, but only 854 of them, or approximately half of the total, had taxable net income in that bracket; that 831, or almost one half, had, after deductions, taxable net income from only fifty to one hundred thousand dollars, and 10 had taxable income from only twenty to fifty thousand dollars. In addition, there are some extraordinary cases.

One person had taxable income only from $10,000 to $20,000, and there was one had taxable income of not over $2,000. Yet all of these people had adjusted gross incomes from $100,000 to $150,000.

If we take similarly the group of single persons and married persons filing separate returns, but with adjusted gross incomes from $150,000 to $200,000, we find there were 610 in that group. But only 258 of the 610 reported taxable income in that bracket; 331 of the 610 reported taxable net income from $100,000 to $150,000, or appreciably less than their adjusted gross income; 18 reported taxable income from fifty thousand to a hundred thousand, 2 from $20,000 to $50,000, and 1, $4,000 to $6,000 of taxable income. Then if we take the last group, those with incomes of $200,000 or more, we find a total of 954 single persons or married persons filing separate returns with adjusted gross incomes of this amount. But only 708 reported taxable income of that amount. This is, of course, a catchall group at the upper end, but there were 217 who reported taxable income of only $150,000 to $200,-000, 24 who reported $100,000 to $150,000, 3 who reported taxable income from fifty thousand to a hundred thousand, and 2 who reported only $20,000 to $50,000, although all of them had adjusted gross incomes above $200,000.

Thus far I have been speaking simply of single persons and married persons filing separate returns.

Now if we take the married persons filing a joint return, of the 13,088 with adjusted gross incomes from a hundred thousand to two hundred thousand dollars, only 8,815 had taxable net income in the hundred thousand to two hundred thousand dollar bracket; 4,215 reported only from $40,000 to $100,000 taxable net income; 46 reported from $20,000 to $40,000 taxable net income; 6 reported only $12,000 to $20,000, and I am informed that these figures are prior to the income splitting provisions.

Then let us take the group with adjusted gross incomes from $200,-000 to $300,000. There were 2,123, in the total group, but only 1,141 reported that much taxable net income; 955 reported taxable income from $100,000 to $200,000; 22 from forty to a hundred thousand dollars; 4 from $20,000 to $40,000, and 1 from $12,000 to $20,000. All of these people had gross incomes from $200,000 to $300,000.

I hope this is not too detailed, but to me it is extremely important.

Then let us take the group with adjusted gross incomes from $300,-000 to $400,000. There were 657 in that group, so far as adjusted gross income is concerned, but only 275 so far as net taxable income was concerned; there were 356 who reported taxable income in the lower category, $200,000 to $300,000; 25 who reported taxable net income from $100,000 to $200,000, and 1 with taxable income from $40,000 to $100,000. I repeat for the sake of the record that this is taxable

income prior to further reductions caused by split income. In the final group, those with adjusted gross incomes over $400,000, of which there were 777, only 571 reported taxable income in that category; 178 reported only $300,000 to $400,000; 21 reported from $200,000 to $300,000; 5 reported taxable incomes from $100,000 to $200,000; 1 reported $40,000 to $100,000, and 1 reported only $20,000 to $40,000. Yet all of these persons had adjusted gross incomes in excess of $400,000.

It seems to me the only net conclusion which one can draw from this is the deductions which are authorized from adjusted gross income, before taxable net income, are so great as to indicate that the apparent degree of progression in the income tax is not in fact realized. If on top of this one adds split income, of course, the degree of progressivity—that is a barbarous word, but it is used—the degree of progressivity is still further reduced.

Mr. BURGESS. Perhaps, Senator Douglas, that reflects the degree to which investors in those brackets have turned to tax-exempt income and have been deterred from investment in taxable securities.

Senator DOUGLAS. It may be.

I am informed by our staff expert, Mr. Ture, that the tax-exempt income is not included in the adjusted gross income figure.

Mr. BURGESS. That is both are stated without tax-exempt income.

Senator DOUGLASS. I think this is important.

I don't know whether I should delay matters any longer. There is one final question I should like to raise about this matter. It is in the public interest to have a net reduction in Government revenues for the fiscal year 1956–57, by an adjustment in rates?

Mr. Keezer, from McGraw Hill, testified that plant and investment is estimated to increase by 13 percent in 1956. Construction is estimated to increase by 5 percent.

In addition, full-time unemployment, that is, completely unemployed is expected to be down to a low figure, though if you take part-time unemployment it would be raised somewhat. Though I have carried on a running fight with Leonard Hall and Secretary Humphrey on the subject let it be said for the record that I do not agree that we are in a recession at the present time.

There are soft spots in the country, depressed areas, but the economy as a whole is not in a state of recession, and therefore in view of this do you think it advisable or necessary to release this monetary purchasing power?

Might it not have the effect of leading to a price inflation, and would it not be wiser to devote this secular increase in revenues to three purposes? I still think Russia is a menace and I think instead of reducing armaments, we should have an increase, particularly amongst the foot soldiers, the low man on the military totem pole. Secondly, I think, as Dr. Hansen mentioned the other day, we have been falling behind in our work in the field of health, education, and to some degree, highways. I notice the automobile industry is in favor of expenditures on highways. Finally, if we have a surplus, why not reduce some of the public debt, that is introduce sound finance?

I throw this out as an alternative to a $3 or $4 billion tax decrease which the CED apparently advocated yesterday, and which some insist is a good thing, and within the tax system, however, we should have readjustments within the general level of rates so that total revenues do not decrease.

We need some readjustment to remove what I regard as—not remove, but to mitigate—what I regard as inequities in the system.

Mr. BURGESS. I should like to comment upon that point of view if I may.

Senator DOUGLAS. Surely.

Mr. BURGESS. In my opinion the economy is now delicately balanced on a high plateau with output pressing against capacity in several key areas and unemployment almost at an irreducible minimum.

In my opinion a tax cut now would add to the danger of inflation, to be followed by a sharp decline, and I would oppose tax cuts under existing conditions.

The situation, in my opinion, calls for a flexible day-to-day policy on the part of the monetary and fiscal authorities.

If some decline in consumer spending and in business activity should occur in the second half of 1956 as some persons foresee, the economy might benefit from the stimulus of a tax cut.

However, the legislative process whereby taxes are reduced lacks flexibility.

It is difficult for Congress to act promptly when dangerous situations arise. It is also well-nigh impossible quickly to revoke a tax cut that might be made.

I think I lean somewhat toward reliance on monetary controls in preference to tax changes to promote economic stability in the face of a very moderate decline, such as may occur late in 1956.

Senator DOUGLAS. I don't want to continue this discussion but in my judgment monetary policies are not very effective in checking declines.

They damped down expansion, but there is little way to make business borrow if it doesn't wish to.

Mr. MILLS. Mr. McCracken, I had one further question I wanted to address to you.

You have stated in the compendium and I think again this morning if I heard you correctly that if the cost of money for financing capital outlays is not fully deductible for tax purposes the imposition of a business income tax will reduce private investment.

Mr. MCCRACKEN. That is right.

Mr. MILLS. I wonder therefore if this conclusion suggests that the Federal corporate income tax should provide a deduction for dividends paid by the corporation?

Mr. MCCRACKEN. In principle yes, but that would raise other difficult problems. The problem which I had in mind was that if some part of the funds to cover a new capital project must be raised by nondebt sources, whether retained earnings or going directly to the capital market with stock, then just simply the arithmetic of the problem means that there are some projects which would be theoretically worth while with no corporate income taxes which would not be worth while when we have corporate income taxes.

Mr. MILLS. Would it be better in the long run, in order to promote stability and economic groth, for these outlays for dividends to be deducted from the corporate tax, than for us to continue this present dividends received credit?

Mr. MCCRACKEN. To deduct dividends from the corporate income tax?

Mr. MILLS. That is right.

Mr. McCRACKEN. Well, I think I would have to think about that. That would put equity and debt money on a more comparable basis, but it is subject to all the problems of an undistributed profits tax.

Mr. MILLS. I have toyed with the idea, I might say, that that perhaps is a better way of approaching this problem that we referred to as double taxation than to do it through the device of a dividend received credit and then of course I am always reminded of the difficulties we encountered in 1936 and 1937 with the old retained earnings problem.

I wondered though, when you made the statement if you were leaning in that direction?

Mr. McCRACKEN. Well, again, I think there is substantial merit to that approach in principle if some of these difficulties, with some sort of retained earnings or undistributed profit tax approach could be worked out.

I am not sure at this point whether they could be.

Mr. MILLS. If they could be worked out would that be a better approach?

Mr. McCRACKEN. It seems so.

Mr. MILLS. Would you comment on that, Mr. Burgess?

Mr. BURGESS. I am not at all hopeful that the difficulties encountered before with respect to an undistributed profits tax can be successfully eliminated and because of that feeling I would oppose deduction of dividends from the tax base of the corporation as a method for remedying the double taxation of dividends.

I would prefer the existing system.

Mr. MILLS. Is it the proper system, though?

Mr. BURGESS. There is no perfect system. All are difficult to administer. There are a number of proposals that have been considered. I am inclined to believe that this present method of dividend credit against the individual income tax is the best of those methods that have been proposed.

Mr. MILLS. When you give credits, though, as we do in this instance for dividends, aren't we inevitably faced with further erosion of the base by the necessity of giving some time in the future an earned income credit?

Mr. BURGESS. That is a possibility, Mr. Mills.

Naturally those who receive no dividend income would be interested in having somewhat similar treatment for the income they do receive.

Mr. MILLS. Why shouldn't they have it if there is this treatment for dividends?

That is the problem that worries me.

Mr. BURGESS. I think there is difficulty in answering your question and especially in supporting a negative answer to it. However, I think the crux of the matter again is the rates and the tax structure.

These gadgets and special provisions to take care of special situations and special groups of taxpayers will not be necessary and would not loom nearly as important if our whole tax structure were lower.

Mr. MILLS. Mr. Burgess, I agree with you completely in that statement that they will not loom as great or be as great a problem but when we continue to approach the problem of taxation from the view of eroding the base—I mean by eroding the base, to removing more of the overall income from the effect of the tax—then we longer post-

pone the day when we can address ourselves to proper treatment of the rate.

Mr. BURGESS. I agree.

Mr. MILLS. All right. Then when you once provide a gadget or credit that erodes the base, and create a situation that some may say is discriminatory, and they are powerful politically, and demand comparable treatment, then don't you postpone further the day when you can do something about the rate?

Mr. BURGESS. I agree. Probably the best solution would be firmly to resist all such pressures and all such gadgets, which of course is impossible.

Senator DOUGLAS. If you will support the removal of these erosions in the tax structure and the restoration of an equitable tax structure, then we can consider reducing the rates.

Why wouldn't it be a good idea for the business community to come in and propose a reform of capital gains, a reform of the depreciation allowance, change of the split-income provisions, withholding provisions at the source for dividends and interest, and then there could be an adjustment on the rate of progression in the tax rate.

Mr. BURGESS. I think there is merit in Senator Douglas' suggestion.

Senator DOUGLAS. I hope you may spread the seed of that idea amongst your colleagues down among the canyons in New York.

Mr. CURTIS. That is exactly what Secretary Humphrey has been advocating and the basic remarks which I made when the committee started the session. The whole business starts from this high rate that has been imposed and then taxes are used as a method of producing some results.

Now whether they are desirable—social and economic results—whether they are desirable or not is what the Congress decides, but looming behind the whole thing is this progressively higher rate.

Mr. Mills refers to the expression of eroding the base. It erodes the base all right but each one of these items that have been put in here have been put in under the various political and social pressures, and the Government—we in the Federal Government are now in position almost where we are utilizing the taxes, not to get revenue, but to produce certain social and political and economic results. I think that that is why I posed the question in the beginning.

Aren't we in a philosophical discussion as to whether it is wise for the Federal Government to use taxes, other than to derive revenue?

In regard to this one point that Mr. Mills raised on this dividend credit, I think there is a typical example in Mr. Mills raising the point of having corporate dividend credit going to the taxpayer level, that immediately there is pressure put on by groups to get an earned income credit.

That is a political, not an economic thing, because the sole purpose, at least to my mind, and I was one of the people that supported this earned dividend credit, the sole purpose of that earned dividend credit was to try to shift more investment into equity and out of borrowing.

That was the purpose that was in the mind of the Ways and Means Committee when they started to discuss it.

They were originally talking about doing it at the corporate level and there was no intention whatsoever to give a break to the investing public.

It was to get the investing public shifted from one type of investment to another type, which we thought, or some of us thought at any rate, was economically better.

Now, if the people who are putting on pressure for an earned income credit would analyze the sole remaining purpose behind the dividend credit, the impression would disappear, but if we keep calling it a method of getting rid of double taxation, which I have publicly said if that is the purpose, I am not interested, because we may have double, triple, quadruple taxation—it is not the equity of the thing.

It is this business of trying to regrettably direct the economy through tax structure.

Now I wanted to make that observation.

I might say too, Senator Douglas, on the split income—and I made this remarks in Ways and Means. This is a social thing, of the arrangement of property between husband and wife and what right a wife should have in her husband's assets. Should it be a partnership—a social and property concept? Certain States picked it up and they said "We think the wife should have this basic interest."

Now whether they are right or wrong, they decided that on a social basis, but it had a terrific impact on the Federal tax structure, and some people came in, not on that basis, but solely on the basis that—I am from a State that is noncommunity property and I should get the same benefit that someone from California gets—and I think we did at least when we extended it, we had some observations in our report, that I asked be put there, that what we were doing was recognizing this basic community property thing. The object, Senator Douglas, was not to give anybody a benefit from split income, although I could not agree with you more, it has had that economic effect, and that tax effect and that is what we get into when we mess around with taxes for other than raising revenue.

Senator Douglas. I do not want to get into a lengthy colloquy with my colleague from Missouri, but since he has raised these matters and addressed them to me perhaps it may not be inappropriate for me to make comments.

First, it is extraordinary how feminism becomes popular for tax purposes amongst those in the upper income brackets, especially if the net effect of the principle of feminism is to reduce the amount of taxes which these people pay.

Similarly, this enthusiasm for increasing the proportionate investment in equity rather than in bonds, is very popular amongst those whose total taxes would be reduced.

I am not charging these people with insincerity at all. Long ago I gave up the attempt to probe men's motives, and having read some of the books by psychiatrists I know the difference between the unconscious and the conscious mind.

All I can say is, it is extraordinary how people can find good reasons to do that which benefits them.

Mr. Curtis. Of course those people come in with pressures for it. I am simply saying, that I as one of the members of the Ways and Means Committee, with Mr. Mills, when these matters came up what was in our minds—and I certainly don't benefit by this, I wish I did have investments, but it can't be for me personally.

You and I both recognize pressure groups will grab hold of any argument they can that they think is logical.

All I am saying is that the thing that came before the Ways and Means Committee was not that this group would be benefited, although I agree they are benefited.

The object and concern was over the economic effect, or rather the economic situation that we saw.

May I ask the panel one question?

Senator DOUGLAS. I want to make a brief reply to that. I would say I have never questioned the motive of the gentleman from Missouri at all.

I know he is a sincere man, as I think virtually all the Members of Congress are, but we should recognize as practical men that though we may as individuals vote on laws, that we are not always entirely free agents.

Mr. CURTIS. We have pressures put on us.

Senator DOUGLAS. The pressures of a community are at least partially reflected in the rollcall votes, and therefore it is not a question of our sincerity but it is a question of the forces which are operating in the community, and what I have been trying to say is that this is in part an economic struggle between people with different economic interests. Our problem is to work out some of those differing economic interests, which are real, not to disregard them, but to try to steer them in such a fashion that we get as close an approximation of justice and efficiency as we can.

I can't resist a temptation to score a point to my good friend, and hope he won't take it amiss if I try to do so.

I was much interested in my colleague's statement that one should keep social considerations out of tax matters, but then I noticed that he was justifying the dividend credit and split income on social, economic, and philosophical considerations, which I think indicates it is impossible to keep out such considerations when deciding policy.

Mr. CURTIS. I might state for the Senator that that was my original observation; that that is what we are doing.

I know full well that there have been many attacks on this measure, that is the consideration for which I voted. But what I have been basically trying to do is cut down Federal expenditures, to get the rates down so we don't have these temptations.

Yes; they exist.

The question I want to ask the panel is in line with what we are discussing here.

Have any observations been made by economists or business people to find out whether this current income credit actually has had any effect in producing more equity capital because I have made remarks on the floor of the House—I beg your pardon, dividend credit, has produced more issuance of equity—has produced more offerings of stock issues as a result of it. I made the statement at the time it was passed, and I reiterate it here that if it is not achieving that purpose as far as I am concerned there is no point to it, and I personally would like to abandon it, if the theory is not correct.

I have asked many people in the business world who advance this philosophy to come forward with some proof of it having any results.

I would like to know if the panelists here have observed any results or heard of anyone who has made any studies?

Mr. BURGESS. There are two items that could be pointed to as evidence that the dividend credit is having a beneficial effect on

investor attitudes, although it is impossible to measure that effect, or to attribute results entirely to the dividend credit. First, there has been a substantial increase in new corporate stock issues over the last year.

Second, there has, as is obvious to everyone, been a substantial rise in stock-market values, a part of which has been attributed to the dividend credit.

Both indicate that the credit has had a favorable effect on investor psychology and attitude toward equity investments.

Mr. CURTIS. Incidentally I might say that I would wonder about the stock market rising. In my own thinking if the purposes I sought could be achieved economically were being achieved, the stock market would not necessarily rise, because I have felt that the demand for equity security and the limited supplies is one of the basic reasons behind the rise. If we were increasing the supply of equity securities, actually the pressures would be so that it would come down and equalize.

Now I agree that it has been such a short time that you could not pinpoint it.

I know in a specific instance that a large issue, I think it was General Motors, of around a hundred million dollars was in equity securities, and the original plans of that corporation had been to issue it in the form of bonds, and whether this new dividend credit weighed at all in their consideration—I understand it weighed in their deliberations.

That is the kind of evidence that I would be looking for if this is more than theory.

I am not satisfied myself that it is actually borne out. I think it can and it looks to me like those results have come about. If they have, I have no apology to anyone, not only for backing that proposition but for continuing to back it and to continue to try to keep it out of the political arena from being presented in the false light that I believe it has been presented.

Mr. MILLS. I think too, Mr. Curtis, you would be interested in the proposition of how various businesses will fare under the device.

That is, is it conducive to the raising of investment capital by small business equally with larger business?

Mr. CURTIS. Yes.

I might say this: That we had a situation at the time that this thing came up where corporations were withdrawing some of their equity investment and financing the withdrawal with issuance of bonds or bank borrowings so we actually had a narrowing of the equity base going on.

I think that has been stopped.

At least from every observation I know we have not had that tendency continued. I think if that has been stopped, I think this device can claim some credit for that.

Mr. MILLS. If there are no further questions or observations, the subcommittee will adjourn until 2 p. m. this afternoon.

(Whereupon, at 12:33 p. m. the subcommittee was recessed, to reconvene at 2 p. m. the same day.)

AFTERNOON SESSION

The subcommittee met at 2 p. m., Hon. Wilbur D. Mills, chairman of the subcommittee, presiding.

Present: Representative Thomas B. Curtis.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The subcommittee will come to order, please.

This afternoon's session of the Subcommittee on Tax Policy will be devoted to discussion of the impact of Federal taxation on management and on entrepreneurial efforts and on type of remuneration, effects on labor supply and professional skills.

As was announced earlier, our procedure is to hear the panelists in the order in which their papers appear in the compendium. At the start of the session panelists will be given 5 minutes each to summarize their reports. We will hear from all panelists without interruption. The 5-minute rule will be adhered to, and I will ask the staff to raise a card when the speaker has spoken 5 minutes.

Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session. I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee members' questions.

Our first panelist this afternoon is Prof. Clarence Long of the Johns Hopkins University.

Professor Long, you are recognized.

Mr. LONG. Thank you, Mr. Mills.

This subcommittee has asked me to report on the question: Does the fact that people must pay part of their income as a tax influence the proportion of the working-age population who are in the labor force—meaning by labor force the number of people with jobs, or seeking jobs, for pay or profit.

In an attempt to answer this question I have made two types of study.

The first study makes use of data on the labor force of wives classified by incomes of their husbands. These data are available from the 1940 census, which was taken at a time when the income tax was so low as not to be effective for the overwhelming proportion of the labor force, and from a census sample survey which was taken at a time (1951) when most income groups were subject to an income tax. The information was not presented by the census on the amount of tax paid by the various income groups but it was possible to make a fairly satisfactory estimate on the basis of certain assumptions. The labor force data of wives were further classified according to age of wife, and whether or not she had young children.

This study shows that wives manifested less sensitivity to changes in income of their husbands (whether or not tax is deducted) in 1951 than in 1940, but that the difference was scarcely significant in the case of wives with young children and only moderate in the case of wives without young children.

This lack of significant difference does not prove that income tax has had no effect on labor force participation. The data were not

entirely comparable and the economic conditions were not the same. Furthermore, the investigation so far refers only to part of the labor force. We turn therefore to our other study.

A rather detailed investigation by this writer, soon to go to press, has found that the overall labor force participation rate has been extremely stable from one high employment census year to another, and that this stability has held over the last half century or more for the United States, for Great Britain, for Canada, for New Zealand, and for Germany. The labor force participation has remained thus relatively stable in all these five countries during periods when real annual disposable incomes, per adult male worker or per capita, were increasing and when marked changes were occurring in the internal composition of the labor force of each country.

The above results were drawn from comparisons of labor force participation and personal income after tax. What would have been the results if the labor force participation had been compared with changes in the tax itself?

A detailed comparison of labor force participation, and the percentage of tax to personal income in these five countries, over the decades yields the following conclusions:

First, there was no tendency for the labor force participation to change in any systematic way with the percentage of personal income paid out in tax. Second, the differences in the labor force participation among the five nations in recent years, when the income tax has been a substantial percentage of personal income in all the countries, has not borne any relation to the size of that percentage.

This does not mean, of course, that the income tax is incapable of exerting manifest influence on the labor force participation. There was only one instance—a minor one—in which a rise in income tax was responsible for leaving the average labor force member with a smaller real income after tax than he had at a previous decade date with a smaller tax.

The decades of the greatest increase in percentage of personal income going to tax were also, generally, the decades of the greatest increase—both absolute and relative—in the real income after tax.

So much for the average tax. Concerning the distribution of the tax among individuals, it may be said that the income tax has not been a major burden on most of the labor force—even in recent decades.

In the United States in 1950, 97 percent of the individual tax returns, including joint returns, reported incomes of under $10,000 and paid an average tax of 10 percent or less of adjusted gross income; and the lack of progressiveness of this tax for most of the labor force is attested by the fact that even the percentage of income going to the top 5 percent of income recipients was not changed much by the income tax.

In Great Britain in 1950–51, 93 percent of persons receiving incomes about £135, paid 8.6 percent or less of their total income in income tax.

Thus, the absence of a manifest effect of the income tax on labor force participation may have been because, during the history of the tax thus far, it has been relatively moderate and unprogressive for most of the labor force.

Mr. MILLS. Thank you, Mr. Long.

Our next panelist is Mr. Robert Schulman, of Washington, D. C.

Mr. Schulman. Mr. Chairman, I have attempted to bring up for discussion by the Subcommittee on Tax Policy some of the methods which are now being used to spread high annually earned income over years subsequent to those years in which it was actually earned. Some taxpayers are enabled to accomplish this result under statutory authority. Others have devised their own methods without any specific aid of written law. There are still others, however, in comparable tax brackets, who are unable to avoid the effect of our progressive tax rates and must report their income in the years when earned.

By way of illustration, Congress has given its blessing to restricted stock options. The larger publicly owned corporations can afford to use this device to give additional remuneration to their key executives and employees. No tax is imposed upon the executive or employee at the time the option is granted or at the time it is exercised.

The only taxable event occurs later when the stock is sold, and then more often than not at capital-gain rates. But the restricted stock option provisions of the statute are not, as a practical matter, adaptable to the small or closely held corporation. Such corporations ordinarily have no acceptable measures for valuing their stock at the time an option might be granted and therefore, the risk of failure to meet the statutory definition of a restricted stock option is too great to entice key employees of such corporations to seek this statutory relief. The statutory provisions for restricted sock opions, herefore, appear to discriminate against small businesses.

In numerous situations where restricted stock options are impracticable, companies have turned to the so-called leverage stock transaction in order to attract and retain key executives and employees. The goal in this procedure is to reduce the present value of stock to a point where a key executive or employee can afford to buy a respectable percentage of common stock equity for relatively little cash. For example, if only one class of common stock is outstanding, new preferred stock may be issued tax free, either by way of stock dividend or pursuant to recapitalization, to the present holders of the common. This tax-free issuance of preferred stock diminishes the value of the common stock and the executive can then purchase common stock equity which may be worth a substantial sum in the future.

Pension and profit-sharing plans which meet certain definite statutory requirements present another, though less effective, method of protecting compensation of key employees from the effects of a high rate of tax. While the social policy behind this legislation is commendable, I am doubtful that the adoption of many such plans is primarily motivated by any feeling of social policy. I believe that some are adopted in order to provide an additional source of remuneration which may be paid to a key executive or employee at a future time when his income is likely to be lower and subject to a lower rate of tax.

Although these plans are helpful, they do not sufficiently solve the key executive's problem as respects the small corporation which must meet outside competition for the services of a key executive or employee.

The methods of deferring compensation so far mentioned are available only to corporate executives and personnel, and then only to a segment of those persons.

There is a substantial group of highly paid persons, such as entertainers, professional athletes, and persons engaged in certain creative activities, who cannot postpone receipt of taxable compensation by way of stock options, leverage stock, or pension and profit-sharing plans. The careers of such persons are normally shorter in term of years than is that of corporate executive. Many of such persons have developed a method of deferring payment of some portion of their services into years following the rendition of their services. This method employs what is popularly called a deferred compensation contract.

The typical contract of this sort imposes certain conditions upon the employee with respect to payments to be received in years following his active services to the employer. One such condition commonly is that if the employee remains in the service of the employer until normal retirement age the employer will pay him a designated amount thereafter for a specified number of years or for life. Other conditions involve agreements not to compete, or to serve in a consultant capacity if requested in later years.

The Treasury has had practically no success in the courts in its attempt to tax any such income in a year or years prior to its actual receipt by the employee. The Internal Revenue Service advised some time ago that it is interested in an overall basic policy in regard to taxing deferred compensation arrangements. So far no ruling has been issued and taxpayers who enter such contracts are subject to the risk of disapproval by the Service of their arrangements.

Such contracts for deferring compensation payments are becoming more and more prevalent, and, in my opinion, it would be wise for Congress to consider the matter presently for the sake of both taxpayers and a sound administration of the revenue, and not, through inaction, allow the tax treatment of such conracts to grow up by accident and happenstance.

Mr. Mills. Thank you, Mr. Schulman.

Our next panelist is Mr. Joseph Driscoll, of Washington, D. C. Mr. Driscoll, you are recognized.

Mr. Driscoll. Mr. Chairman, my subject is income averaging for individual income-tax purposes.

One of the most acute inequities of our present tax system is its impact on individuals with fluctuating income. If the income of an individual changes materially from year to year, he is subjected to substantially greater taxes than the individual who receives the same amount of income in more nearly equal amounts.

For example, a single person receiving $100,000 of taxable income in 10 equal installments pays an aggregate tax of approximately $19,000. If the same total income is received in uneven amounts, the tax may amount to twice that figure.

This inequity affects many sectors of our economy. Small-business men and individual enterpreneurs frequently encounter drastic changes of income. They may experience several lean years in the process of establishing a business enterprise and then find their profits concentrated in a few years. The farmer typically has good years and bad years. Writers, composers, and entertainers often have wide variations between earnings in successive years. The professional man, lawyer, doctor, or architect, usually must spend years developing

his skill before he begins to realize substantial earnings. In each of these cases, individuals suffer a severe tax detriment by comparison with those who receive a steady income.

The harsh effects of the present tax structure as applied to varying incomes has been recognized by writers and students of tax law for some time. There have been several piecemeal attempts to deal with the problem in existing law. For example, the 1954 code provided 3-year averaging of income for the proceeds of certain insurance policies; it also liberalized the rules for the spreading back of income to prior years where the income is attributable to services rendered in such years. Several foreign countries, and our own State of Wisconsin, have at one time or another provided for averaging of income. At the present time, Canada allows 5-year averaging for farmers and fishermen.

There are basically three types of proposals to help those with fluctuating income:

(1) A carryover of losses; (2) a carryover of exemptions; and (3) a general average plan.

The carryover of losses is now widely accepted in our tax structure. The 2-year carryback and 5-year carryforward appears to provide substantial relief for the individual who incurs an actual loss.

A carryover of exemptions would provide greater tax equity for those in the lower brackets who may lose the benefit of their exemptions because of illness, unemployment, or other circumstances. However, the carryover of exemptions would considerably complicate the tax law for millions of low-bracket taxpayers. The problems of tax administration would also be increased substantially.

A general averaging plan would lessen the impact of the progressive rate structure on persons with fluctuating incomes. The most practical type of averaging plan would be one which meets the following conditions:

(1) It should limit the relief of those cases in which there are sharp fluctuations of income; and

(2) The individual who qualifies should be permitted to spread income back over a designated period of years.

A plan of the type described would avoid the objections which have been voiced to averaging plans in the past. It would be relatively simple and easy to apply. It would not require any tax computations or adjustments for the millions of taxpayers whose income remains stable. Most important of all, it would provide a positive incentive for businessmen, artists, professional men, and others to make a maximum contribution to the economy. These individuals would expend far greater efforts if they had some assurance that the proceeds of their activity would not be subject to discriminatory taxation merely because it happened to be concentrated in a period of a few years.

In conclusion, an averaging plan would add an important element of equity to our tax structure. It would provide impetus for the establishment of new businesses, the creation of new products and artistic and increased output by persons in diverse segments of the economy.

Mr. Mills. We thank you, Mr. Driscoll.

Our next panelist is Mr. Crawford Greenewalt, president, Du Pont, Wilmington, Del.

Mr. GREENEWALT. Mr. Chairman, I am not an authority on taxation nor am I an expert on budgetary matters. My views are those of an executive who faces the practical problems of insuring for his corporation continued competence and abundance of top managerial personnel.

As our country has matured, we have become increasingly dependent on an active and dynamic industry for our economic growth and prosperity. It follows that how industry succeeds must be of great impotrance to all Americans. Such success depends substantially on the caliber of its management group, and their job becomes more difficult as our industrial technology becomes more complex.

Each field of endeavor has its own type of incentive. In the academic world, prestige, and recognition attract gifted minds even though financial compensation is unjustifiably low. Politics affords an opportunity for public service and attention.

The arts and the theater offer the goal of fame as well as fortune. In pure science there are awards such as the Nobel prize.

In the armed services, incentive is based on rank and perquisites. Even the church has its hierarchies and symbolic tokens of achievement.

Business is in a poor position to compete in these important intangible areas, and so must rely mostly on financial incentive. As it becomes increasingly less able to do so, it will lose its ability to persuade qualified people to enter industry or to advance to their maximum capacity. It is here, as I see it, that our danger lies.

I believe the effectiveness of the money incentive is being eroded by the upper-bracket tax rates prevailing today. Present executives and their immediate successors are reasonably immune, for the challenge and associations of their work present an incentive offsetting reduced financial motivations. There remain two problem areas.

1. The effect of high taxes on long-range money incentives will make it increasingly difficult to persuade able young men to enter industry. I ask here not to improve industry's position opposite other fields of endeavor, but to maintain it.

2. Increased difficulty in persuading capable employees in sight of their top capacity to keep on going also traces to high tax rates. When a promising executive declines to try for the $64,000 question, everyone is the loser.

The hard fact is that the chief loser on either of these counts is the American citizen. He wants lower prices, expanded employment, job security, prospects for advancement. He wants better schools, medical facilities, care for the aged, cultural facilities. He can have them, with our rapidly expanding population, only if industry grows better managed rather than worse.

This is why all of us must be concerned about any threat to the future successful operation of industry. I see such a threat in present high-income tax levels. In that important area, I hope the deliberations of the Committee on the Economic Report will produce helpful data and valuable conclusions.

Mr. MILLS. We appreciate your statements and the information that you and the other panelists have given us in the compendium, and in your appearance today. The Chair understands that Mr. George Break of the department of economics, University of California, could not be present today. He is out of the country.

Permit me to begin the interrogation, Mr. Curtis, if I may.

As you know, the primary objective of this study is to find the basic economic principles which should guide Federal tax policy in order to assure long run economic growth and stability.

I have said that at the commencement of each interrogation of each panelist or group of panelists. I don't want us to overlook that as being our primary function and responsibility.

We recognize that one of the most important determinants of growth is the size of the labor force and the effectiveness of incentives for extra personal effort.

In your opinion, and I will address this to each of you, what aspects of the Federal tax system may have a bearing on this growth factor, and what is the magnitude of the impact of these features of the tax system?

I will start with Professor Long.

Mr. LONG. As I pointed out in my opening paper, so far as the overwhelming proportion of labor force is concerned, I can see no effect of the tax in the past, either incentive or disincentive. Thus, I suppose your question would be, What can we do to produce a greater incentive effect to bring people into the labor force in larger numbers in the future?

Mr. MILLS. That is right.

Mr. LONG. I think we ought to keep in mind in considering this question a further question, namely, whether we necessarily want more people in the labor force. There are always social and cultural costs involved in bringing large numbers of extra people into the labor force. It isn't always a good idea for a woman to leave her children home for somebody else to take care of or to run around the streets, just so we can have a large labor force. There is a great deal to be gained from young people postponing their entry into the labor force in order to stay in school to later ages. Women have been entering the labor force in very large numbers in recent years, but their entry has been balanced by an exodus of elderly people and young people, leaving the overall labor force participation rather stable.

However, if your object is to increase the labor force participation rate, there are a number of things you could do that might bring still more women into the labor force. In the case of my own wife, who now and then considers working, the problem is always that she gets the income and I pay the tax and the other expenses of her working. I object to this, and so far she hasn't gone in.

These costs—of having someone take care of the children at home, of seeing that the house is well run, of eating out, and so on—mean that there is very little net gain in my wife working, from my point of view.

If Congress decides that we do want more people working, it could provide a tax offset to the large number of expenses that the woman has in working.

That is enough at this point.

Mr. MILLS. Professor Long, I had in mind that I would like you to discuss, if you will, what we can do, in the way of incentives, to increase the effort by those presently in the labor force, as well as to enlarge upon the labor force.

Taxwise, you understand.

Mr. LONG. I have no comment to make on that, Mr. Mills; there are others here who are better qualified to answer that particular question.

Mr. MILLS. Mr. Schulman, do you care to answer the combination of questions?

Mr. SCHULMAN. I will try to answer parts of it.

I am, unfortunately, not a policymaker or economist, for that matter, or an executive. I am just a journeyman lawyer and I am talking from having had the opportunity from time to time to work with a few clients on this problem. Maybe the best way to start it is to say that someone once made the statement that it is easier to draft men than money. Maybe in the past part of our income-tax legislation has been subconsciously based on that principle, and I think that one of the practical disincentives to the extent there is one—and there I have to bow to the economists as to the degree of it—against executives is the distinction, and the disparity which is growing wider and wider year by year between the effective tax rate on capital increment and nicome as against the effective tax rate on personal-service compensation.

The result has been that the taxpayers have tried to develop means of spreading their income, or getting it into some sort of capital-gain form. In some respects they have been aided by Congress, but the congressional approach up to now hasn't been an overall, with all due deference, considered approach.

It has been more of a buckshot approach, handling one or another aggravated, or what seems to be aggravated area at a particular time.

For example, the last one, the last Congress put through some legislation that a professional inventor gets capital gain treatment on the sale of his inventions, whether for royalties or for lump sum or otherwise, and it is understandable that authors and writers and other people who create with their minds as against perhaps creating with their hands, and who don't get the same treatment are a little bit up in arms and I think that the executive's big problem today is that if he works and is paid a hundred thousand dollar salary, and manages by dint of his efforts to increase the value of the stock of the corporation owned by some absentee stockowners by the same amount, the stockholders have a benefit far greater than the executive.

I am not pleading that they are the only people to be taken care of but I am saying that if there is any validity to the position that we need top-flight executives, and apparently the competition for them in the market place today is fairly keen, then perhaps this disparity ought to be reconsidered, and I would think that the basic policy questions here to be considered by the committee are, Do you want to continue to sharply discriminate in favor of capital investment gains and income as against personal service compensation, and then second, Do you want to favor certain types of personal service compensation as against others. The way things are under the present code, you do favor certain types of compensation as against others, and finally, to what degree are you willing to vitiate or limit the annual accounting principle where a taxpayer must report all of his income that he receives within a 12-month period within that period, even though, as Mr. Driscoll has pointed out, it may represent the fruit of several

years of efforts, in order to equalize the tax burdens on different types of personal-service compensation.

Mr. MILLS. Mr. Driscoll, will you address yourself to the question?

Mr. DRISCOLL. Yes, Mr. Chairman.

I have been studying the application of the tax system to those with varying and fluctuating incomes. In this field we do have a marked trend. The present tax system, based upon an annual accounting requirement, tends to impose positive detriments to the growth of the economy.

There are perhaps two primary categories in this field: Those who have fluctuating income because of the changing demand for their talents, and those who are engaged in business operations, such as the farmer or small-business man, where competitive factors and technological changes may cause income to vary considerably from one year to the next.

It is quite clear, I think, that a heavy tax penalty is imposed on such individuals by comparison with those who have the good fortune to receive a steady income or to be engaged in a line of business where income is relatively more stable. I would say that the present tax system, which requires that income be determined and the tax be computed annually without regard to the income level in other years, does have a deterrent effect on such individuals. If we could have an averaging plan which is sensible and practical, there would be a positive incentive for additional effort by individuals in this category.

Furthermore, investment in several lines would be made more attractive if averaging of income were provided—so that when income is concentrated in 1 or 2 years, consideration could be given to the income level in prior years.

These trends are quite noticeable in the field of personal talent which, as Mr. Schulman said, seems to be taxed much more heavily than capital investment. There are a number of individuals who reach the point each year where they withdraw from further productive activity. There is no incentive to additional economic effort because of the burden of taxes.

The application of the progressive rates on a single year-by-year basis does tend to encourage certain types of investment. This additional investment occurs where individuals are in a high tax bracket. They may undertake expensive hobbies or other activities with a view toward spending their income and obtaining the benefit of a tax deduction. Much of that expensing of income is tax inspired, I think it could be eliminated in large measure if the tax system were to apply more equitably to those with fluctuating incomes.

Mr. MILLS. Mr. Greenewalt?

Mr. GREENEWALT. Well, Mr. Chairman, I think I have given my point of view in my introduction.

It seems to me, to answer your question specifically, that the most serious element of present tax policy operating against future growth and development is the steeply progressive rate of personal income taxes.

Now, when we speak of growth and development we are speaking of the performance of people. A corporation is nothing but people, a university is nothing but people, and the important thing for maximum growth and development is that each one of these people puts out his greatest potential effort in any area of endeavor that he chooses.

Unfortunately, perhaps in a spiritual sense, that effort requires incentives of one sort or another; and so it seems to me the most important thing that we have before us is to provide a sufficient variety of incentives—fully effective—to make each one of us put out the best that is in us.

Mr. MILLS. You are saying, I guess what I have said on occasions myself, that in order for us to have stable and continued growth, it is necessary that those that we expect to create the growth, that is, the American people, at all times have an equal opportunity of gain with loss.

Mr. GREENEWALT. That is quite correct and that they have that opportunity of gain, with no holds barred.

Mr. MILLS. Well, there would have to be some I guess.

Mr. GREENEWALT. I was rather amused when Mr. Driscoll said that these artists quit after the year is half over. I think that if I were motivated solely by what I put in my pants pocket I would quit around January 2.

Mr. MILLS. Well, since you bring in yourself as a personal example, I think I know what your answer will be before I ask the question, but you do, I presume, exert as great an effort after January as you did during the month of January, do you not?

Mr. GREENEWALT. Well, I hope so, sir. I hope our board of directors thinks so at least.

I would hate to be fired. No. I think that is true. I try to make the point in the extended remarks that are in your record, that I am not really speaking of this problem in terms of the present crop of managerial talent.

I have worked for the Du Pont Co. for nearly 35 years. They have treated me well. I am in the swing of things, and I am conditioned perhaps to go ahead and do my best.

The thing that worries me is the young fellow, the guy that is going to be, not my immediate successor but my successor in the years to come. He is the one that has got to be pulled along, not me. I am hooked.

Mr. MILLS. Well, you present a question that I have had in my mind to ask the panel a little later. Let me ask it of you now.

If this young man to whom you refer feels that the tax structure deters him from going into Du Pont with the possible objective of some time taking your place when you retire, what is there left for that young man to do, possessing the talent and qualifications that he possesses?

Where can he go in our economy under our tax structure?

Mr. GREENEWALT. Well, Mr. Chairman, I have this very firm belief, and that is that potential competence is not limited to a given field.

In other words, if you have a bright young man at 22, let's say, he could probably advance and reach high places in a great many different fields of endeavor, and if he turns his back on one, where the incentives are primarily financial, because they are not real, then he will go into one where they are not financial, but perhaps mean more to him in terms of the intangibles.

I don't want to talk about myself, but I was trained as a scientist. As a matter of fact I spent 25 of these 35 years in the laboratory.

Now I might very well indeed have elected, thirty-odd years ago, to stay in science, and let's say instead of trying for the presidency of Du Pont Co. to try for a Nobel prize.

Maybe I would have gotten it, maybe I would not, but that might have meant more to me today than what I have now.

Mr. MILLS. But not as a result of the tax structure.

Mr. GREENEWALT. Oh, yes, indeed, because you see the thing is that when you go into a business career you have the opportunity of making some dough, and if you are good enough, quite a lot of it. If you choose the sciences you turn your back upon the money end of it largely, and you aim for the prestige and renown that a given degree of accomplishment in the sciences give you.

There is a certain balance wheel there. A man has many different motivations, perhaps a great complex of them.

There are various motivations, but certainly financial compensation is a balance wheel that you can put in the scales against the more public forms of prestige.

Mr. MILLS. Professor Long?

Mr. LONG. I would like to comment on Mr. Greenewalt's observations.

Let me begin by saying that I have no real opinion on whether the income tax rates on the upper incomes are excessive—though they do strike me as being awfully high as absolute amounts, I am primarily concerned at this point with what are the economic effects.

Now this is an area in which I have spent a few years of my life investigating. It is an area in which there has been a struggle between theories for several hundred years: Do high taxes act as a deterrent or do they act as an incentive? The discussion is still in the realm of theory. Nobody has ever yet been able to answer this question from any real investigations of what actually occurs.

I have not seen any evidence on this question. I would like to see some of it. I don't think it is yet forthcoming.

As Mr. Greenewalt himself points out in connection with other walks of life. people are motivated in many different ways, by many different considerations besides those of money. Why shouldn't this diversity of motivation apply to businessmen also? I doubt very much whether this conception of a person "going into business only for the dough" is realistic. It doesn't do justice to Mr. Greenewalt or to his friends in business. People who go into business undoubtedly do so for a great many reasons; I suspect businessmen are becoming increasingly altruistic and motivated by other than solely monetary reasons. In any case, the rewards of going into business are very great on other than pure monetary grounds. You can see business leaders in public and other honorary positions all over the place. They get Cabinet posts.

Mr. CURTIS. That is more recent.

Mr. LONG. More businessmen get Cabinet posts than professors, let me tell you.

Mr. GREENEWALT. That is only recently, too.

Mr. LONG. They may not get Nobel prizes but economists don't get them either.

When they say things, the press pays attention. They are men of power and influence. I think they enjoy that kind of life.

Furthermore, hard work—the struggle for success—is not the kind of a thing the average businessman can turn off and on, in response to the income tax. He can't decide he is going to work just so hard and then stop when his taxes begin to mount.

When a business friend of mine had gotten through expatiating at some length on how the tax destroyed his incentive, his wife said, "Dear, if you stopped working hard, you would lose your job"—and, as a matter of fact, he did, not long after.

I was interested in Mr. Greenewalt's proposition that if businessmen are not allowed to keep more of their incomes, not the present generation but future generations of businessmen will be deterred from going into the business.

Now everywhere I go, among economists and among other social scientists, I hear the same complaint, "Able people are not coming to us."

The scientists are filling the pages of the newspapers with this refrain: That the bright people are not coming to them. They have all kinds of arguments why—either the public schools are not sending them into science or they are not being paid enough—and you should hear the humanities on this question.

My assumption has been that if they are not coming our way they must be going into business. Now I hear Mr. Greenewalt complain that he does not see them come into business· Actually, the standard complaint about America has always been that we have been too industrially conscious; that our best brains have gone into business. Certainly I think business in the past has gotten its share, and I suspect it will get its share in the future. On the other hand, I think that to an increasing extent our future economic development is not going to depend exclusively on entrepreneurial brains, but will be dependent also on the staff work, the laboratory work, the accounting work, the financial work, and so forth, that go along with the development of any business. Thus, our job is to keep a balanced distribution of talent among all the fields. What our tax structure ought to be in order to provide this balanced situation I don't know. We need more facts on it.

But what we have had so far is opinion. Even where it is sincere opinion, it is too frequently based on a particular speaker's own very limited experience.

Mr. Mills. Professor Long, we call your attention to the fact that those of us in political office have never felt that there has been any deficiency of those willing to enter upon the political scene.

We do not attribute that to any connection with the tax structure. It just happens to be a fact.

I was amused at one of the earlier panelists saying, he is a college professor himself, that they are finding a great scarcity of individuals who desire to proceed to obtain a doctor of philosophy degree because of the attractive industry opportunities for doctor of philosophy candidates, so that even there there is a deficiency in numbers.

Mr. Driscoll, in your statement that appears in the compendium, I think you assert that the absence of income averaging for tax purposes induces investment in stable taxed business as opposed to more dynamic enterprises.

Have I properly interpreted your statement?

Mr. Driscoll. Yes, sir.

Mr. MILLS. Can you offer us any objective evidence that investment involves a tax penalty on irregular incomes, and therefore tends to activity has been so affected by the Federal tax structure?

Mr. DRISCOLL. Investment activity as such, I think, is adversely affected in the area of small-business enterprise. Individuals have to think twice before they invest funds in an operating business where the taxes may be much heavier than if they were to make the same investment, say, in real estate, which produces a stable income over a period of years.

In some lines of business where income fluctuates, potential profits may be greater. On the whole, however, it would seem that there is a substantial tax detriment, assuming the same level of profits, to investment in a business where the profits may be substantial 1 year and nothing the next year.

We do know that, were it not for the carryover of losses, there would be a severe tax disadvantage incurred by several types of enterprises.

The loss problem has been corrected. The rate problem remains. It seems to me that rates that range up to 90 percent will cause people to think twice before they undertake investment in unstable activities.

Investors may, of course, be lured on by an opportunity for sale of the business at capital-gains rates. If that possibility exists, there is motivation for developing the business with a view toward ultimate liquidation and sale. However, the tax system should not put a premium on the sale of these businesses. Yet where income is sporadic, the only relief may be in the form of a sale to another concern, so that the benefit of averaging through the use of the capital-gains rates may be obtained.

There is more marked effect on economic incentive insofar as the tax rates apply to persons exploiting their own talents, such as those engaged in creative work or professional fields, entertainers, composers, and so forth.

It is this area particularly where investment perhaps in terms of one's personal effort, investment in terms of schooling, and so forth, may be impeded by the present tax system. By comparison, an individual who goes to work for a corporation may have a steady income and the assurance of a pension or profit-sharing plan at the end of his career.

Those are factors which an individual must take into account before he undertakes his own business.

Furthermore, many of those engaged in entrepreneurial endeavor may withdraw because of tax detriments and hire themselves out to a corporation.

Mr. MILLS. Do you consider that the present tax structure is conducive to hiring out to a corporation versus becoming a proprietor of a business?

Mr. DRISCOLL. I think there are definite tendencies in that direction.

Mr. MILLS. Is the tax structure causing it?

Mr. DRISCOLL. Yes, sir.

Mr. MILLS. Point out to me, will you, the features of the tax structure which do lead to that result?

Mr. DRISCOLL. I would say, for example, an individual who is conducting his own business as an architect, and may have very high profits in one year and low profits the next year, might be in a much

better position to accept long-term contract with a corporation, or with some other group, that will assure him steady income over a period of years.

Mr. MILLS. You think the averaging of income, then, might well correct that?

Mr. DRISCOLL. I think if some averaging were allowed it would tend materially to eliminate that, and above all it would encourage persons in the fields of fluctuating income to maximize their contribution to the economy.

Mr. MILLS. Mr. Schulman, do you have some comment on that?

Mr. SCHULMAN. Yes.

I am not quite sure I agree completely with Mr. Driscoll. In the case of his architect, his architect might well be influenced to form his own corporation and operate in corporate form and draw a reasonable salary from it, and have this fluctuating income, which his corporate company could average out if it had any operating losses and to the extent it is averaged out it would pay a flat 52-percent tax anyway.

Certainly in the entertainment field, as a matter of experience, in the last 3 or 4 years what has happened has been twofold.

One development, you sit in front of your TV camera and it says the Willie Lump-Lump show and at the end of it it says produced by Willie Lump-Lump, Inc.

Many of these entertainers become producers and produce a packaged show. They are forced to become entrepreneurs themselves.

Being entrepreneurs, they run the risk and are taxed like any other small-business corporation.

The other development that has happened in recent years is that a TV or radio, or stage or motion-picture personality who spend 10, 15, or 20 years knocking around the nightclubs, and suffering the heartaches of experience until he gets his big break and then catapults to prominence in 1 or 2 years, as we have indicated, can't spread back all that income but what he does do is spread it forward, and it is a very curious set of circumstances that comes up.

The employer, the RCA or CBS of the situation, are willing to pay X million dollars and, generally speaking, they don't care which way it is paid.

They want that fellow to appear for the next 39 weeks or 78 weeks on the TV screen and they will give him, let's say, $3 million, to do it, but he says, I don't want it all at once.

He says, "I want so much now and also I will agree not to compete for the next 10 years and you agree to pay me X dollars a year during that 10-year perod."

Well, there is a certain amount of controversy as to whether or not that kind of a contract will stand up to defer taxes, though I think in certain situations it will, but I urge that perhaps it is high time that the Congress consider these problems, and consider them out in front instead of letting the Internal Revenue Service and the courts allow the development of the answers in these things to grow up by accident.

Mr. MILLS. Do you desire rebuttal, Mr. Driscoll?

Mr. DRISCOLL. I would like to add one point.

It seems to me that the present tax system encourages devices of this kind. It would make a great deal of sense to prescribe some method in the law whereby an adjustment of income could take place without the necessity of entering into dubious contracts, and setting up questionable corporations, primarily with a view toward overcoming the effect of the present tax system. We could simplify the tax law immeasurably by having some type of averaging plan that would make unnecessary a great many of these gimmicks.

Mr. MILLS. Mr. Greenwalt, may I submit a further question to you?

Several of our panelists in previous sessions have indicated that there are excellent prospects for substantial tax reduction in the level of rates over, say, the next decade, without significant change in the degree of progression in the rate structure from one bracket to another.

Do you think under these circumstances that effort and initiative will be weakened by the Federal tax law?

Mr. GREENEWALT. I want to be very sure I understand you.

You say that the general level will be reduced, without a change in the slope of the progression.

Mr. MILLS. In the progression; that is right.

Mr. GREENEWALT. In other words, you might make a 10-percent reduction in the brackets all along the line.

Mr. MILLS. Across-the-board, or even a 25-percent reduction.

Mr. GREENEWALT. That would certainly help.

The thing is that——

Mr. MILLS. Let me get the record straight. I am not talking about this year, 25 percent.

Mr. GREENEWALT. I am sorry to hear that.

Mr. MILLS. I mean in the long run.

Mr. GREENEWALT. Mr. Long put some words into my mouth that I did not think were there, but it seems to me that quite obviously there comes a point in this progression scale where the additional effort, coupled with the additional responsibility, simply is not worth it.

Now to say quantitatively where that comes I don't know. Certainly it is ridiculous to say that a 25-percent rate would stop anybody, because that is saying that a man will work for $1 but not for 75 cents which is foolishness.

On the other hand when you get up to the point that a man may work for $1 but not for 9 cents, I think it is a very real thing.

Where that point is, how high is the rate for progression to go in order to preserve the desire of a man to go on to the next step, I just don't know. I think when you get your rates up to 91 percent, you are getting to the point that you really do damage to incentive.

How much below you could put it and retain incentive I don't know. I would say at 50 percent, surely, at 70 percent, maybe.

Mr. MILLS. What I am trying to understand with respect to the question is whether in your view it is the rate itself or the degree of progression within the structure that you fear as a business executive, or that individuals in the future may fear.

Mr. GREENEWALT. I think it is the rate itself, not the fact that you have a progressive structure. It is where you get to when you reach the top rate.

Mr. MILLS. I wanted the record to be clear on that point.

I thought that would be your answer.

Mr. Schulman, one further question, and I will defer to Mr. Curtis.

I believe you attribute the devices used by high bracket income earners to avoid the full impact of current income taxation to the progressive rates of the income tax?

Mr. SCHULMAN. That is one of the things and I think another thing is the disparity between capital gains rates and ordinary income-tax rates.

I am fully aware that we need a certain basket ot dollars to run the Government and Armed Forces, and so forth, and I think you just have to have those dollars as long as we are in a cold war situation, but I think that an executive is a little bit disgruntled when he finds that his brother bought some stock in January and just sat on it and sold it in August and keeps more net than the executive himself got for working those 6 months, in the same dollar symbols.

Mr. MILLS. Is it the fact of progression that leads to these devices we are discussing, or is it the level of the rates?

Mr. SCHULMAN. I just don't know the answer on that one. In a practical sense, I think the taxpayer is interested in his net keepable cash.

Mr. MILLS. Regardless of whether it is reduced by progression or by rates?

Mr. SCHULMAN. Yes, and I think what he is interested in, and I think the last 10 or 15 years have pushed a change in thinking, he is not interested in being No. 1 on the list of highest earners for the year or something like that, so much as he is interested in having a certain element of security, and interested in, well, "what is going to happen to my wife and kids after I die?"

Mr. MILLS. Do you have any thought on that, Mr. Long?

Mr. LONG. Perhaps these gentlemen do not quite realize the implications of their answer. I think it really must be the progression, as much as the rate, that would exercise this disincentive effect—if the disincentive is there. Remember, I think so far we have been given mere theory, and that it has not been adequately demonstrated that there is a disincentive effect. But nevertheless let us suppose for the moment that there is a disincentive effect. If everyone had to pay a 91 percent tax, for example, this would be a very high tax, but it would not be a progressive tax. Isn't that right?

Mr. MILLS. Yes.

Mr. LONG. If such were the case, then it would be extremely difficult for a business executive to back away from this 91 percent tax because he would have no place to go. In any other job he took, or at any lower salary he chose to work for, he would be subjected to a 91 percent tax also.

Indeed, if everyone had to pay a 91 percent tax regardless of income level, a situation might well prevail in which everybody was working very hard in order to make up for that enormous loss of income and thereby to maintain a certain standard of living. I think the answer is that both the level and progressiveness have to be considered. But don't forget that very high and progressive taxes can have a powerful incentive effect, through the very great loss of income. A great-grandfather of mine who was able, through lack of tax, to accumulate so much money that at 50 he quit working and never worked again in his life. A very high income tax might have kept him from

accumulating that much money and may thus have forced him to keep on working until much later in life. In a sense a very high income tax can have an incentive or "treadmill" effect as well as a disincentive effect. Equally good theory can be marshaled to support either expectation.

We need to find out what exactly does happen in actual fact. I for one haven't yet seen the evidence on this.

Mr. MILLS. Is the theory of this proposition correct: That in order to obtain optimum economic growth in the United States, there must be exerted maximum effort by all of us in the working force here in the United States; is that true?

Mr. LONG. Agreed.

Mr. MILLS. It is that factor that I have in the back of my mind in asking these questions, when I ask whether it is the progression in the rate structure, or whether it is the level of rates that offers a deterrent, if there is a deterrent, to present maximum effort on the part of our labor force, our entrepreneurs or the others engaged in business activity.

We have no data, I assume, on which is more deterring, if either are deterring?

Mr. LONG. So far as I know, we have no data at all on this question, except what I have marshaled, which is simply on the number of people who have come into the labor force.

Mr. GREENEWALT. Mr. Mills, may I make a comment here on your original question to me: Ever since we have had an income tax it has been progressive.

As a matter of fact, even 30 years ago, it was progressive, but the top rate was not very excessive.

As a matter of fact, I think for a good many years, the top bracket was 25 percent.

It also seems clear that as long as you exclude anybody from the effect of the income tax you have automatically a progressive rate structure.

It seems to me there is nothing inherently wrong and a great deal that is inherently right about the principle of progression.

The thing that gets messy is when the progression is so steep, or the rates at any level so high, that you have a disincentive effect.

Mr. MILLS. Are you saying in part that we have too many brackets?

Mr. GREENEWALT. No.

What I am saying is that the rates rise so steeply that at the top, they amount to a disincentive, in spite of Mr. Long.

Mr. MILLS. I think many students of taxation, would say that for many purposes, we have too many brackets too, and that perhaps results in actually the extreme steepness of the progression.

Mr. SCHULMAN. Could I put a question perhaps which is this: Would Mr. Greenewalt feel the same way if the disparity were not so great, or if there were less disparity, either one, between the rates on capital gains and unearned income on the one hand, and the rates on personal service compensation, salaries, and so forth, on the other?

Mr. MILLS. Do you want to respond to that, Mr. Greenewalt?

Mr. SCHULMAN. I am not asking a loaded question. I just don't know the answer.

Mr. GREENEWALT. As I say, I hate to talk about things that are outside of my field of experience.

This capital gains question of course is a very difficult one, but I doubt that anyone can very long continue to make money, year after year, by that method.

As a matter of fact, some of your panelists who have already appeared and are to come, talked a great deal about escape routes for people in the high income tax brackets.

Well, either I have been very stupid or they are wrong, because I have not found any of them.

This question of capital gains means first that you have to have property, and that it has to go up in price.

Well, now, I can assure you that that is an exceedingly difficult thing to arrange year after year so that you can count on it for your bread and butter.

I think that capital gains is an entirely different matter. That involves the question of what happens when property increases in value.

It is not a source of income, of that I assure you, at least not a reliable one, so that it seems to me capital gains is really outside of this discussion if I may say so.

I think the question is, what are you going to take from the guy who makes money by the sweat of his brow, or by the possession of lucrative investments.

Mr. MILLS. And at the same time, have tax policy that permits economic growth and stability in the long run.

Mr. GREENEWALT. Absolutely.

That is the important thing really. The country is more important than the individuals, who compose it, and I think everyone of us would agree that the growth and stability of the Nation as a whole is the really important thing, but I think you always come back to the fact that that is going to be done by people, putting out out their greatest possible effort.

Mr. MILLS. Well, let me get to the $64 question, the one I have been leading up to, and I will be through.

Is the present tax structure deterring maximum effort by individuals in the fields that you studied to any appreciable extent, and if so, what effect would a continuation of that situation have upon the economic growth and stability in the United States?

Mr. GREENEWALT. I think I have given you my answer, probably in several different ways, Mr. Chairman. I say that they are too high.

Mr. MILLS. The rates?

Mr. GREENEWALT. The rates are too high. The fault is not in progression, per se, but in the heights to which it has been taken in terms of actual levels, and I feel very strongly that if rates are continued at that level, it will have, in time, a strong disincentive effect and in that sense, will affect growth and stability in the future.

Mr. MILLS. Your answer to my question is "Yes."

Mr. GREENEWALT. The answer is "Yes."

Mr. MILLS. The present tax structure does prevent economic growth and stability in that respect.

Mr. GREENEWALT. I would put it more this way: I think it does. I am sure it will.

Mr. MILLS. A continuation of it will?

Mr. GREENEWALT. Yes.

Mr. MILLS. Mr. Driscoll?

Mr. DRISCOLL. Yes, sir.

In response to your question as to the disincentive effect of the present structure, I definitely do feel that continuation of the present rate system, as it applies on a year-by-year basis with high progressive rates, will have a marked effect on small-business operations.

Mr. MILLS. And therefore prevent——

Mr. DRISCOLL. And therefore prevent the growth of small business.

These individuals will be employed in some other capacity. They will go to work for corporations; they will go to work for the Government.

They will not be working for themselves. I think that where they have started out as entrepreneurs, they could make their greatest contribution if they could continue in that role.

Mr. MILLS. Mr. Greenewalt has said that even in the case of the executive in a corporation, there is this deterrent to maximum effort and growth.

You say in the case of the entrepreneur, the small-business man, there is this deterrent.

Mr. DRISCOLL. Yes, sir. There is a difference at the level at which it takes place. In the case of the small business where income may be substantial in one year and very low the next, the disincentive may occur in the range of income from $10,000 to $25,000 a year. In the case of a corporation executive, the disincentive effect may not occur until you have reached the figure of $50,000 or more in annual income.

Mr. MILLS. But in either instance somewhere along the line present rates if continued will defeat the purposes that we have in mind here, of economic growth and stability.

Mr. DRISCOLL. I was speaking mainly about the entrepreneur, the individual who operates his own business or the person who makes his talent available for hire.

Mr. MILLS. In either instance there is that deterrent to maximum effort, and therefore maximum growth.

Mr. DRISCOLL. Yes.

If I may refer to your question on progressivity of the rates, I think the degree of progressivity is the very problem in the area of fluctuating income.

The degree of progressivity creates the difference in tax burden between the entrepreneur and those individuals having more stable income.

There is also the psychological impact of steeply progressive rates. The individual fully realizes that if his income is concentrated in one year he is going to pay an extremely high tax.

This knowledge affects the individual in a hundred different ways. It affects his decisions as to whether he will make the additional effort, spend the extra hours, and so forth, in order to create products that would increase his income.

It seems to me that in dealing with creative persons, such as artists, entertainers, professional people to some extent, there is a disincentive effect because of the impact of the tax rates, psychologicaly, on these individuals.

They are less inclined to make an extra effort in certain years, because they will then be penalized under the tax structure.

Mr. MILLS. Mr. Driscoll, isn't it a fact that the steepest progression actually occurs in the very lowest brackets?

Mr. DRISCOLL. I think that only occurs in jumping from the zero bracket to the 20-percent bracket.

Beyond that point, if you examine the progressivity, it is fairly low for the first couple of brackets.

In the first bracket, it goes from 20 to 22.

I would say that we should not look at the progressive rates merely in terms of mathematical percentage of increase. Rather we should consider at what point the individual is going to feel that the tax rates are excessive.

Fortunately, there has been a change in progressivity that occurred without much notice or attention. That was in 1948 when the privilege of split-income was granted to married persons. Split-income had tremendous effect on the progressivity of rates.

It has been pointed out that split-income, in effect, cut the progressivity in half above the first bracket.

That was a considerable advance, I think, insofar as the level of progressivity is concerned. Consequently, married persons are not now subject to the 50 percent rate until they reach an income bracket of approximately $30,000 whereas a single person is subjected to the 50 percent rate at approximately $15,000. We have therefore had a real change in progressivity of the rates in recent years.

It would seem that further attention ought to be given to this subject. Certainly in the case of the entrepreneur the present rate structure poses a serious problem.

Mr. MILLS. Mr. Schulman, will you comment on that question, please, sir?

Mr. SCHULMAN. I want to add a small minor dissent to this disincentive conclusion. I can't intelligently say that here is no disincentiveness.

But I think this: I think in practical operation, a corporate executive today does not have to come off too badly. The optimum result for a corporate executive when he enters a contract to run the company or run the production department, or anything, are numerous.

For instance he gets a basic salary which enables him to support his wife and kids in the standard in which he would like to be accustomed to live or something like that, second, he can get a stock option which he can pick up later on and realize ultimately at capital gain rates, third, he gets in the pension or profit-sharing plan and if they pay him out further in a lump sum later on that is capital gain too and if it is paid out in the company stock, there is no capital gain on any appreciation in value of the stock.

Next, he can try to get a deferred compensation contract, and next he gets the usual fringe benefits, group health, group life, free medical attention, possibly free legal service, and things like that.

Now query: With all of these things and when you put them up in a ball of wax, whether an 87 percent rate, or whatever the effective rates, are really what they seem to be.

I do say when you tell a man you will pay him $200,000 of ordinary income and only that, that here is some element of disincentiveness.

My theme is that the rates as they now exist, applicable generally to executives and employees, force them either to go into these, and seek these side advantages and benefits, or there is a disincentiveness if

they can't get those benefits, and that some corporate executives get them, others can't, and other types of employees who are not corporate executives can't and have to work it out some other way.

I say you should pull this problem out in front and look at it.

I think that these rates compared to the rate—I have the feeling, for whatever it is worth, that earned income is entitled to a more reasonable relationship, tax-treatment wise, then unearned income, than income from dividends, and if there is any merit to the theory that the managerial group are the ones that we need to get the best effort from for future economic growth, then maybe the Congress should give some serious consideration to that.

The way it stands now, they are not equal. The personal compensation taxpayers are way behind the others, but I do think that the present tax structure forces people, and their tax advisers, to go to these side efforts to minimize the effective rate, and a great degree of that is going on in various fields, and there are two discriminations.

One is capital gains as against earned income generally, and then one is within the class of earned-income earners, depending on whether they work for a big corporation that can give them all of these benefits or work for a small corporation which may not be able to, or are self-employed, or are independent contractors or spend 20 years writing a book that hits the Book of the Month Club in 1 year, or something like that.

Mr. MILLS. Professor Long?

Mr. LONG. I want to make a rejoinder to Mr. Greenewalt's and Mr. Driscoll's comment that the very high and progressive income tax is slowing up economic progress, or that it will slow up economic progress in the future, in other words, that it will keep people from putting out their maximum efforts.

I never thought I would find myself in position of defending the income tax. I really detest the income tax, and I can fully sympathize with somebody who pays even more income tax than I do.

But there are two points of view from which to consider this problem. One is equity. The other is, What are the actual economic effects, quite aside from your theories based on what you think people will do?

Now, much as I don't like the tax, much as I would like to see it come down, I see no evidence that the high income tax has had the effect of slowing economic growth or slowing effort. Indeed, I can marshal several points of fact to the contrary.

In the first place, we have probably never enjoyed, except for brief intervals, a more rapid economic growth than we have since our income tax has become very high. The 1920's was a period of high economic growth but the period since 1940 and especially since 1947 has been in many ways a rather amazing period; and not just in the United States but also in Great Britain where the income tax is even more heavy than it is here.

Now, let's take a contrast. Let's take some other countries. Incidentally, not very many countries are able to collect a high income tax. They don't have the machinery, they don't have the ethical standard that enables them to enforce it, or that obliges people in good conscience to pay it.

I can think of several European countries—relatively modern nations—where a high income tax is not paid, and yet where the

economic growth, or rate of economic progress, has been distressingly low. The fact that the effective income tax has not been high in those countries hasn't had the result of giving them a good rate of economic progress.

Let us again look here at home. On the one hand, in our own country, the people who are doing the hard work are increasingly the people in the upper-income brackets; the business and professional groups. On the other hand, the great recipients of leisure in our society are increasingly the low-income groups.

Thus I sometimes think a little better case could be made that our income tax has probably had more of a treadmill than a disincentive effect. I am not sure that I would regard this as an equitable thing. I am not sure I regard it as moral for society to dump most of the worry and responsibility on a relatively small group of people and then tax the blazes out of them. But so far as the effect on economic growth is concerned the case has not been made that it is slowing down economic progress, and I see no real signs that it will do so in the future.

Mr. MILLS. Mr. Curtis will inquire.

Mr. CURTIS. I have been very much interested in this particular subject and read the papers with a great deal of interest and followed this discussion.

One comment I want to make before asking questions is, I notice you talk about incentive, but I think we have been confusing incentives for various things, and some of the papers are directed to the incentive to work as opposed to not working, let's say.

Other papers are more concerned with incentive for promotion, people not content with where they are in the economic structure. There is an incentive to remain with a particular employer, and I want to ask some questions on that; then there is an incentive to be in a certain kind of endeavor, both as to form of endeavor, whether it is corporate or unincorporated, or what, and then the nature of the enterprise itself.

I think Professor Long, as I get it, your attention is mainly directed to this incentive to work as opposed to not working, and I would like to pose to you a specific problem that was before the Ways and Means Committee last year when we were revising the tax bill. There was a question of giving women exemption for baby-sitting costs, and I raised the question at the time of whether we shouldn't limit that to women who had to work and not just give baby-sitting costs to a wife of a working husband, but that maybe we would be creating a social pressure that isn't good.

A lot of people think that one reason for the problem of juvenile delinquency is women moving into the labor market. On a particular thing like that, of course, all we could do was go on theory. Don't you think, though, that had we given to any women the right to take baby-sitting costs as a deducation, that would have been a real incentive to having her go into the labor market, or do you think again that is the kind of thing that is still so theoretical that you have to try it out?

Mr. LONG. Well, as a professor I suppose I ought to defend theory, but I have so often found that what you expect on theoretical grounds doesn't come about on investigation. On theoretical grounds, I agree

with you; it would seem to me that to give women deductions for baby sitting—and there are many other costs incidentally for a woman working besides baby sitting, but lets' make that a symbol of the cost—would increase the incentive to work. But whether it would actually have that effect, I don't know. We live in a complex world, where people are motivated to do things by "skeenteen" number of considerations. Usually, a great many things happen to cancel out or obscure the result.

However, I would say, as a matter of equity, that if you are going to allow deductions for baby sitting and other expenses, it shouldn't be done for just low-income families but should be done for families on all levels of income. I live in a community that I suppose would be regarded as upper middle class. In that community a great many women are working so that their children can go to private school or to college. To them it is just as important and necessary that they work as it is for a person who is in a much lower income bracket. As concerns the economics of what will happen if you allow deductions, I would say you are right on theoretical grounds, but what would actually occur I wouldn't know.

Mr. CURTIS. I tend to agree with you, too. I had often wondered about these theories and then we never find out whether they have actually produced the results we intend. Incidentally, that is one reason I tend toward the philosophy of not using our taxing power to try to attain certain social and economic results. I wonder if we shouldn't be thinking a great deal more toward its basic purpose, which is to get revenue.

I just was posing it, though, as a specific thing that happened to come up which fits right in with your discussion.

Now, to get on to this incentive for promotion, which to me is one of the more serious subjects we have, I thought Mr. Greenewalt's handling of that was just tops. I think anyone who reads that page will look beyond this idea of money. I thought it was very courageous for a businessman to put it that bluntly, because I think that money incentive is certainly a very powerful one and as he points out that is one of the big incentives that exists in business.

I would like to make a comment on your statement, Professor Long, in regard to the fact that we have had this great productivity in 1946.

I agree that we have, but I wonder where we can look for the cause. I suspect that we sow the seeds, or I mean we reap the seeds that have been sowed for us by people who have gone before, and I suspect that we are reaping today the benefits of procedures and setups that have occurred before.

I think Mr. Greenewalt in his paper tries to point that out. He was not concerned about this present group of business executives, nor the ones that are coming right up the line now, but what is going to happen 20 years from now.

What kind of a business executive are you going to get then? What is the importance of this incentive for promotion?

We see it in all areas here in Government. When we get into the business of drafting men for the military service, our Career Compensation Act for the military, trying to get the talent we need into our military organization, where we set up our civil-service structure in such a way, we hope, that we can attract the talent that we know we need

if we are going to do these jobs in Government, and this business of incentive and promotion to me is really serious. Although, of course, if our tax structure is keeping people from working at all that would be very serious.

I agree with Professor Long; I don't believe we know enough to know what we are doing on this incentive for promotion.

Mr. GREENEWALT. Mr. Long has spoken as if there were no evidence. There isn't much but there is a little.

We had one case that I remember extremely well in the Du Pont Co. a number of years ago where we asked a man to take a job with considerably more responsibility. He turned it down. He turned the job down simply because, he said, "Well, it is a new business to me, it is not the particular phase of our business in which I have been engaged. I have got to learn a lot of new things. I am fifty-odd-years old. The amount of money that is in it is not worth the candle and I wouldn't like to have the job."

Now, that is one case. We have had a great many cases of lateral moves, moves which had as their motivation the broadening of a man's experience, that he refused to take because of the expense involved, and the increase we offered him after taxes wasn't enough to make him go from, let's say, Chicago to Detroit.

All these things involved a move in location. There is some evidence this thing is working. It isn't very much now and as you said so well, Mr. Curtis, I was not speaking of the present so much as I was of the future, but there is a little bit of evidence that some men—by no means all of them, thank the Lord—are not making moves because of the net after taxes.

Now, if I could at this time, too, because I sort of had it on my mind, comment for a moment on something Mr. Schulman had to say a moment ago, if that is in order, sir?

Mr. CURTIS. You mean about the various techniques used?

Mr. GREENEWALT. Yes.

I would hope that that would not leave with you an impression that is a little erroneous, and there I am afraid here again I have to get personal. I put down as Mr. Schulman recited them the list of things that represented these gimmicks that people use, and what I have to do in order to be factual with you is to appraise them against my own experience. Well, (1) I have no stock options; (2) I have no deferred compensation. I do have a pension, if I work another 12 years, but that is limited in amount. It is not proportional to what I have been earning in my career. I pay my own lawyer's bills, I pay my own doctor's bills.

Unfortunately, my situation is such that I can't take advantage of the split income provision that has been talked about here. I have no tax free income, and at least in 1954, I had no capital gains.

Now, the result of that, Mr. Chairman, is that every penny that the Du Pont Co. paid me in 1954 was taxed at 91 percent, so that at least there is one person who has not been able to find any gimmicks.

Mr. MILLS. May I interrupt? I think you want to correct the record, not every penny paid you by Du Pont would be taxed, at 91 percent?

Mr. GREENEWALT. I mean precisely that.

Mr. MILLS. You do?

Mr. GREENEWALT. I do indeed. It still remains, sir, that every penny the Du Pont Co. paid in 1954 to me was taxed at 91 percent.

Mr. MILLS. That would include salary, bonuses?

Mr. GREENEWALT. Salary and bonus. Now, I have an independent income.

Mr. MILLS. That would also be included?

Mr. GREENEWALT. No. What I said was that what the Du Pont Co. paid me for the job I hold with them, all of that was taxed at 91 percent.

Mr. MILLS. That is in the top bracket, in other words?

Mr. GREENEWALT. So that I have none of Mr. Schulman's gimmicks and I think there are many others in the same position.

Mr. SCHULMAN. I can understand Mr. Greenewalt's possible disincentiveness.

Mr. GREENEWALT. Let me hasten to say I still work.

Mr. CURTIS. I did want to comment on those various methods of spreading income, to this extent.

That is perfectly true they inure to the benefit of the individual, but they have to conform to the way Government directs, so it isn't free dollars by any manner of means. It has to be done in certain ways the Government directs and we are the ones that have to figure out the way, or what channels shall be open in the way of additional compensation.

I want to get on with these other two things, to just briefly point them up if I may.

The incentive to remain with a particular employer: I have talked a lot with a lot of people and listened to a lot of testimony.

It strikes me that because of these various gimmicks, if I were to call them that— I don't want to refer to them exactly as that. It has almost gotten to be that there is a corporate peonage, that has existed where a man starts to work for a certain corporation and after he builds up certain benefits, he is pretty well stuck as far as shifting his job, and that to me has come largely because of our tax structure.

It is something that disturbs me very much, very much. Again, we are not talking about the general bulk of people I would say, but more in an area of the people who are going to be the top brass of the industry.

Do you have a comment on that, Mr. Shulman?

Mr. SHULMAN. I didn't mean to imply that there was no disincentiveness or that most of these gimmicks didn't have to conform to certain statutory requirements.

Mr. CURTIS. I know that. I was just commenting.

Mr. SHULMAN. Nor that they were universally applicable. I think Mr. Greenewalt is not unique. I think most executives are without many of these gimmicks but I merely point out that in the competition today for the labor market, the optimum that an executive is looking for is some or all of these benefits, and that some executives who are able to obtain them do not pay taxes as an executive at an ordinary income-tax rate, that you could figure out just by looking at the rates.

Mr. CURTIS. I got your point.

I was simply carrying it on to really develop this other point, of this incentive to remain with a particular employer or turn it around the other way, the inability of a man after he has worked so many years

for a particular corporation to have a freedom of choice in moving, which I think has a very serious economic implication, and aside from the economic implication there is a personal problem that is involved, because most of these gimmicks which you point out are available to the corporate form and the larger corporate forms of doing business, which comes to the further point, incentive to be in a certain kind of endeavor; that is, first, (a) by that form of business, whether it is a corporate form, and I might say there is a big place where large corporations, or more stable corporations as opposed to one that is just getting started.

One place Mr. Greenewalt I think we can certainly find this worry that you have of the future of a business executive is at the college level, with boys graduating from college and finding out what their interests are, and their drives for security, which seems to be involved here, and the ability of a particular kind of business organization to get their services. It goes back to the structure of the tax, I believe. I believe the more Federal regulations there are, the better competitive opportunities large corporations have over small businesses, because they have the overhead, of lawyers, accountants, and so forth, to cope with the regulations, interpret them, and so forth.

Smaller businesses are hampered by not being able to cope with them. We have written into our tax laws certain provisions that only corporations can get the benefit from, and it gives a power to your corporate form and your larger corporate form to compete more successfully against other kind of methods of doing business.

Then the nature of the enterprise, which to me is quite intriguing, too, and I am very much interested in Mr. Driscoll's paper, for he points out that in discussing or averaging this income that it was this element of what kind of venture you go into.

If it is a risky type of thing, you do have your fluctuating income, because we set our taxes on an annual cycle which we do for the individual generally. We have written in some of these averages, but we have never had a comprehensive averaging written into it, but at present, while doing something on this subject of averaging out, we are giving a great deal of economic advantage to an industry or enterprise that is in a more stable form.

I would like to ask on that: Have you ever figured out, Mr. Driscoll, the revenue cost of an averaging plan? Of course, they would all vary, but——

Mr. DRISCOLL. No, sir; I haven't. It would have to be done by a staff of economists who were in position to analyze the extent of fluctuating incomes in the economy.

For example, among farmers there is considerable variation of income from one year to another.

There is an article in the compendium which indicates that farmers, especially those in Great Plains States, experience irregular incomes. They may have high income one year and low income the next year. It would be necessary to consider varying incomes among professional people, lawyers, doctors, and others.

Corporate employees may in some instances experience changing income levels. Sometimes they are elevated quickly from one position to another, and that may change their income status.

Then you would have to consider certain activities, such as entertainment and professional athletics, to determine the amount of fluctuating income in those areas.

Having done that, one would then consider in detail the type of averaging plan proposed. I think I ought to mention that the revenue loss depends largely upon the type of plan.

If an attempt is made to average the income of every individual in the country from year to year, not only would it be extremely difficult to do it administratively, but it would be quite expensive.

Mr. CURTIS. We are talking about the ones that fluctuate.

Mr. DRISCOLL. I think if you limit averaging to sharp fluctuations in income, there would not be any great revenue loss, since the adjustment would in any particular year be confined to a rather limited number of individuals. However, such relief would encourage vast numbers of individuals to exert their maximum effort. They would have the assurance that no matter how much money they made in 1 year their taxes would be adjusted under an averaging plan.

Of course, they might undertake such effort without ever achieving that kind of income. However, it is the expectation of profit which provides the incentive.

The problem has already been recognized in the statute with respect to certain types of artistic compositions and services rendered over a period of several years. It seems to me that the statutory provision is wholly inadequate. It has several limitations which may, in fact, cause bunching of income in order to meet the technical requirements of the statute. Also, it applies only to those producing artistic works and not to the farmer, the small-business man, or many others who may experience bunching of income in 1 year.

Mr. CURTIS. Incidentally, the smaller the person the more benefit, if he is in an area of fluctuating income like a farmer, the more effect it would have on him because he would lose his ordinary exemptions in the year when he made no money and not have it passed over to when he had a big crop season.

Mr. DRISCOLL. Yes, sir.

I pointed out that is one type of averaging proposal. You can either have a carryover of exemptions; you can have averaging as to rates; or you can have both.

I would also like to mention one point that is relevant to what has been said by the other speakers. Mr. Greenewalt said that business was anxious to obtain its share of the bright young men.

Professor Long suggested there is a demand for them in the field of education and science. I would plead for still another field, namely, entrepreneurship.

It seems to me entrepreneurship is losing out all the way along the line. It is highly desirable that young people be given maximum encouragement to establish a small business of their own, run their own farm, or become independent contractors.

This is an extremely dynamic and important component of economic life which ought to be encouraged.

Mr. CURTIS. I couldn't agree with you more. Having been on the Small Business Committee of the House, and feeling very deeply that the growth, healthy economic growth comes from your small business, and, of course, small business hopes to become large. In fact, all large

businesses were small at one time, who were efficient, and went on and prospered.

I have been disturbed about the lack of this new growth that comes into our enterprise which comes from this source and I know you know Mr. Driscoll, having done considerable work on a bill I introduced, to average incomes, which I am hopeful that the Ways and Means Committee will hold hearings on this year.

Incidentally, one final thing: We were talking in previous panels about building in some flexibility into our tax structure, and addressing myself to some remarks you made on page 183, you said, "For example, in a period of rising price levels and increasing incomes a general averaging provision might blunt the edge of a tax increase designed to reduce inflationary pressures."

Do you believe that if we did get an averaging income proposal to become law along the lines I introduced that it would give some additional built-in flexibility?

Mr. DRISCOLL. I would like to comment first on the statement you referred to. It is true that in a period of rising prices, when the Congress might be desirous of imposing higher rates, averaging would permit individuals to spread their income over prior years in some instances.

However, I think that any practical averaging plan must necessarily be limited in scope. It would not apply to the great mass of indivduals but only apply to cases where there was extreme inequity.

Therefore, there would be no substantial impact so far as the effectiveness of fiscal weapons is concerned.

Mr. CURTIS. Whatever effect it would have would be one toward flexibility.

Mr. DRISCOLL. It would be necessary to define what is meant by flexibility. Averaging provides greater flexibility for the individual entrepreneur in that he is free to go ahead and earn income without trying to stagger his operations or create artificial situations solely for tax reasons.

Mr. CURTIS. I was thinking more of the overall economic effect: what it would be. One may have a tax reduction one year, or you might consider the tax reduction on the overall economy. This provision being in the law, that would tend to make the economy a little more stable to the extent it was in the law.

Maybe stable is not the word I want to use.

Mr. DRISCOLL. Let me point out one or two things. An averaging plan does not affect the receipt of income. The income would still be subject to tax at the rates applicable in a year of receipt. However, progressivity of the rates would be blunted by treating the income as if received over a period of time.

It seems to me that if the averaging system is properly worked out it would not in any material way affect or mitigate the impact of taxes as you contemplated they should take effect.

Mr. CURTIS. Thank you.

Mr. MILLS. Mr. Ture, the staff member will inquire.

Incidentally, he is our expert.

Mr. TURE. Before I address a question to the panel I think perhaps I might make one technical comment on the effect of averaging on built-in flexibility. When we talk about built-in flexibility, we are

talking about the reaction of the tax yield, in the absence of rate changes, to changes in income.

What we want is built-in flexibility such that when income rises income after tax rises but not so much, and when income falls income after tax falls but not so much. There is at least one type of averaging device, which in the circumstances of a fall in income, would enhance built-in flexibility but which unfortunately during a period of rising income would tend to diminish built-in flexibility.

I would like to address this question to you, Mr. Driscoll, to bring out some of the details of this averaging proposal:

You suggest that one qualification which would be required would be a sharp fluctuation of income. Could you be a little more precise in defining what you mean by "sharp fluctuation"?

Mr. DRISCOLL. Yes.

I will state the problem first of all. If we are to have tax averaging, it should not apply where an individual, say, earns, $9,000 1 year and $10,000 the next year, and the third year is back down to $9,000 again.

Those are routine changes in income which do not necessitate the application of any averaging system. It is only when income rises for example from $10,000 in 1 year to $30,000 in the next that there is a real need for averaging.

I think a line has to be drawn at some point, and it is up to the Congress to decide where that line might be.

Mr. TURE. Would you say the line should be a 10 percent change in income?

Mr. DRISCOLL. No. I think anything less than a 25 percent dividing line would not be suitable because it would require adjustment by too many taxpayers.

Mr. TURE. As I understand the basic area where averaging is required, one of the conditions that you must meet in order to have a really sharp inequity, is a substantial change in tax liability because of fluctuation in income, necessarily implying that the individual who primarily requires averaging is in the upper end of the income distribution, because at lower levels of income, even very substantial changes of income won't make much of a difference in tax in absolute terms.

Unfortunately, as you get to the top of the income distribution you find the income brackets for tax purposes become very broad. Suppose we took your 25-percent criterion, and we were concerned about income fluctuations of an individual who has $100,000 or more of income. For example, suppose that in this year, he has $100,000 of income and next year he has $150,000 income. I note that an averaging device will not help him. He is still in the same rate bracket.

Mr. DRISCOLL. That is quite correct. I think, though, averaging is primarily concerned for the one who goes from a $3,000 or $4,000 income level to $15,000 or from $70,000 of income to $25,000 or $50,000. If you look to those rate brackets there is a substantial difference in tax under an averaging plan.

Mr. TURE. Of course, the reason why you suggest an arbitrarily determined percentage limitation is to make sure that your averaging scheme would not embrace so many people as to make it administratively impossible. What I am suggesting is that an awful lot of people

who might very well be entitled to averaging on the basis of any of the circumstances that you outline would be precluded from using it, by a limitation as high as 25 percent, but on the other hand, if you lowered the minimum percentage limitation, you would get more and more people in, making this seem impractical.

Have you given any thought to how you can weave your way through the broad outlines of an averaging scheme so as to avoid depending on a specific limitation?

Mr. Driscoll. I would say that a balancing of the factors is required. It is true that once you have reached the $200,000 level and the individual is in a 91-percent bracket, a percentage increase in income means nothing since there is a flat rate at that point. However, that is not the problem we are concerned with. The entrepreneur is not ordinarily going to be earning $200,000 a year. He is lucky if he can raise his income from a few thousand a year to $15,000.

The median brackets are the area for concern, but then only if there are material changes in income from 1 year to the next.

I might mention that proposals have been made which would gear averaging to percentage changes in tax liability instead of gross income.

Mr. Ture. May I address a question to Professor Long?

Do you think the type of tax devices that Mr. Schulman described may have a significant effect on the allocation of the specialized and skilled-labor resources that are so important to growth in our economy?

Mr. Long. Which proposal specifically?

Mr. Ture. Well, the things which we have called gimmicks, perhaps unfortunately; arrangements such as stock options, deferred compensation contracts, leverage-stock arrangements—in other words, devices which operate primarily through the tax system, and not through attempts to measure through salary or other compensation arrangements the actual value of product contributed by the resources in question.

Mr. Long. I have no real technical competence to bring to bear on the type of problem that Mr. Schulman is talking about.

My comments up to now have been mainly to point out that we have been speculating on these problems without any real objective knowledge about what actually happens.

I think there are quite good a priori grounds for believing that there are people in the country who are working hard to get out of paying taxes. I don't think these things affect enormous numbers of people. Perhaps the people they affect are particularly important people, so far as the operation of our economy is concerned. But in all these things you have to keep in mind that the further up you get above the hunger level, the more complex your motivation is. A person on the very bottom level has got to think entirely of keeping alive and therefore he thinks entirely of income.

The farther up you go the more possible it is for you to think of other considerations: convention, glory, self-expression, altruism, desire for power—there are all kinds of reasons why people work.

The evidence I would like to see on these matters is not what people say they do, because I don't trust what people say they do. I don't

trust even what I say I do myself, because I frequently don't even know why I do things. To analyze my own behavior I find is an extremely complex thing. Thus, when a man says he is turning down a particular job because of the tax, frequently what you are getting here is a conventional response.

If he said, "To tell you the truth I can't stand responsibility, I am afraid of taking a chance on this job because I fear I will be demoted and everybody will say I did not have it in me," he knows you would not respect him. So he gives the conventional answer—the answer he thinks will meet with approval.

I go for objective measures based on what people do, not what they say. This slows you down in speculating on economic behavior, but you are more sure of what you have got.

Mr. TURE. I think the point of the question is this: That we have been discussing here this afternoon primarily the effect of certain aspects of the Federal tax system on quantities of labor and skilled services.

I think another equally important question is the effect of the Federal tax system on how efficiently a given quantity of resources is being used.

Now I think one of the things we ought to think about is whether or not a special tax device or some features of the tax system have a distorting effect in the use of this very limited amount of very highly specialized and very highly prized resources.

That might represent a loss of far more significant proportions than a loss in terms of mere quantities.

Mr. DRISCOLL. Mr. Ture, could I make a comment on that?

I think the point Mr. Long has mentioned is significant, it is hard to tell as yet what the real effect of these gimmicks is. However, we should realize that this entire problem is in a dynamic state.

It has only been in the past 15 years or so that we have had such high tax rates that people are looking and casting about in various directions for various tax gimmicks. Nevertheless this is a growing problem.

The way the drive for gimmicks has been mushrooming in the past few years it is going to be a much bigger problem as time goes on. Even though it is not too serious yet, we should consider it as a continuing threat. Unless some more mature way is found to provide equity in the tax system and a more balanced rate structure, such as changes in progressivity or in measures, such as averaging, which would eliminate some of the inequities you will find that businessmen, entrepreneurs, and others are spending a major part of their time with tax lawyers and accountants. All of this time is directed toward one purpose, to modify in some way the direct impact of the tax system.

I would suspect the matter will become worse unless some remedial measures are taken.

Mr. GREENEWALT. Could I make a comment, Mr. Chairman, that is appropriate to the remarks that Mr. Curtis made?

Mr. MILLS. Mr. Greenewalt.

Mr. GREENEWALT. There is one aspect of this question of entrepreneurs that I do not think has been given such sufficient emphasis. I certainly agree with the idea that America can't do without them. You have been discussing entrepreneurs from the point of view of the

tax impact on them, which assumes that they are in business and have made a start.

I would like to make this point: That the important thing is to back sometimes the man with a crazy idea, who has not got any of the conventional sources of financing.

Have you ever stopped to think how far Mr. Henry Ford would have gotten had he made his invention in these days?

If you will remember, a great many people thought he was completely nuts.

The only way he got backing was by getting a few friends who knew him and understood him and had faith in him to risk their own money in what he was trying to do.

He could not go to the bank. No bank would lend him a dime. He got his money from wealthy people, who had amassed a certain amount of this world's goods and who were willing to back him up with their own money.

Now it seems to me there are two things that are important there: One is that the people who are going to back that kind of a venture be able to afford to lose, because of course the chances are that the idea will be crazy, and that the people who put their money up to back it will lose it.

That is probably much more likely to happen, than it is not to happen so that the first thing is that the man must have—the backer must be able to afford to lose what he puts up, but on the other hand if that sort of thing is not possible—and it is very difficult in these days—the guy with the crazy idea that may turn out to be exceedingly important will not get the backing that he needs.

And this is long before you get to the problem of how he is going to average out what money he makes.

This is before he makes any money. The idea here is to give him a chance, and that I think is exceedingly important, so far as the future is concerned.

The brilliant individual who wants to start out for himself, with an idea, that he has the financial resources supplied to him some way so that he will.

Mr. Mills. You are saying in a different way what Professor Hansen said the opening day of the hearings, that to a great extent the economic growth of the future and stability of the future will depend not upon just capital outlays alone, but upon invention and the development of new processes and new articles and new devices.

So we must plan a tax policy that will permit the utilization of those ideas.

Mr. Greenewalt. Wherever they come from.

Mr. Mills. From whatever source.

Mr. Greenewalt, everyone has had an opportunity in recent days to express an opinion on tax reduction you will notice.

You have made some suggestions to the subcommittee with respect to long-range tax policy.

In the event that we reach a cash balance so that some consideration might be given in the fiscal year ahead of us to tax reduction, or payment on the public debt or enlargement of Government service or the extension of new Government service, would you feel that that would

be the time when we should make a beginning in the elimination of such deterrents to incentive as may presently exist?

Mr. GREENEWALT. I would certainly think so.

Mr. MILLS. Again, to continue in the labor force, or to acceptance of greater responsibility within the labor force?

Mr. GREENEWALT. Well, the problem of Government revenues is something that you people will have to deal with.

In other words, the net tax burden on the economy is a thing that depends upon many factors.

It seems to me that the important thing in any given net tax burden, whether it is forty, fifty, sixty, or a hundred million dollars, is so to levy taxes that the economy goes forward nevertheless.

Mr. MILLS. But would you use any part of that surplus, if that surplus develops as we have been told it may, for purposes of immediate remedial action in this field?

Mr. GREENEWALT. Well, if I were one of your members I think I would certainly plump for it.

Mr. MILLS. Would you use it for purposes, Mr. Driscoll, of averaging income in accordance with your suggestions immediately or would you delay that?

Mr. DRISCOLL. My own view, Mr. Mills, would be that correction of inequities in the tax system should have the top order of priority, if it can be done without too much loss of revenue. There are several areas in the tax law, even following the 1954 code, where adjustment should be made. If there is a surplus, this is the time to effect corrections which will make the tax system more equitable, and which will encourage investment.

Mr. MILLS. You would do it immediately then?

Mr. GREENEWALT. I think that should be done.

Mr. MILLS. Mr. Schulman?

Mr. SCHULMAN. I think I join with Mr. Greenewalt and Mr. Driscoll.

I think the time has long since come when the overall question of executive and other employee incentive should be carefully considered by the Congress.

Last year the Congress gave a dividend credit and it seems to me if there is any available fund this year they might well consider this point, looking at how to give more incentive to executives through the tax structure.

Mr. MILLS. Professor Long, do you care to comment on the proposition?

Mr. LONG. I think I have no comment to make.

Mr. MILLS. If there are no further comments by the panelists or further questions by the subcommittee, the subcommittee will adjourn until 10 o'clock tomorrow morning.

(Whereupon, at 4:12 p. m., the subcommittee was adjourned, to reconvene at 10 a. m., Thursday, December 8, 1955.)

FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

THURSDAY, DECEMBER 8, 1955

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON TAX POLICY OF THE
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The subcommittee met at 10 a. m., the Honorable Wilbur D. Mills, chairman of the subcommittee, presiding.

Present: Senators Paul H. Douglas and Barry Goldwater, Representative Thomas B. Curtis.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The subcommittee will come to order, please.

This morning's session of the Subcommittee on Tax Policy will be devoted to discusion of the relative emphasis in tax policy on encouragement of consumption or investment.

As was announced yesterday, our procedure is to hear from the panelists in the order in which their papers appear in the compendium Federal Tax Policy for Economic Growth and Stability.

At the start of each of these sessions, panelists will be given 5 minutes each to summarize their papers. We will hear from all panelists without interruption. The 5-minute rule will be adhered to and I have asked the staff to raise a card when the speaker has spoken 5 minutes. Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session. I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee's questions.

Our first panelist this morning is Mr. John C. Davidson, director of Government finance department, National Association of Manufacturers.

Mr. Davidson, you are recognized.

Mr. DAVIDSON. Thank you, Mr. Chairman.

May I first say that it is quite a privilege to be able to participate in this most important investigation and to be associated with a group of such distinguished panelists.

The sum and substance of my views, and of the association I represent, is that tax policy should not be used as a means for manipulating the economy or for other nonfiscal purposes.

The goal of tax policy should be to raise the necessary revenue as equitably as possible by means of available tax methods—not to favor

nor to penalize, not to encourage nor to discourage, and certainly not deliberately to influence the course of economic events.

Certainly, redirection of tax policy toward such a goal would open up new horizons of economic freedom, progress, and well-being. No matter how deeply present tax policy may be rooted in the academic and political literature of our times, it is nevertheless a fact that the policy is one of discrimination, not minor but major, not inadvertent but intentional; discrimination which strikes at the heart of a free economic system.

The incompatibility of a discriminatory tax policy with a free economic system may be readily demonstrated by practical illustration. If a man works overtime, his reward from his private employer will be a higher rate of pay, but if he gets into another tax bracket his Government penalizes him.

A salesman will work harder, produce more business, and get higher commissions from his employer, but higher tax rates from his Government. It is an incongruous situation when the Government will penalize a citizen for doing what everyone agrees merits extra reward from his private employer.

Reduction in taxes does not stimulate economic activity, but it does remove or moderate whatever the repressive or deterring effects of preexisting rates may have been.

I do not think anyone can seriously claim the Federal tax system is repressive as regards the consumption expenditures of taxpayers who are not subject to progressive rates.

On the other hand, the record before this committee is replete with recognition of the restraining effects of high-tax rates on savings and investment, a recognition sometimes begrudgingly given even by panelists who see nothing inherently wrong in the high-rate policy.

For myself, I do not understand how anyone could consider the present income-tax-rate structure, as visually shown on the attached charts, without comprehending the punishing and discouraging effects that such rates have on economic incentives and risk taking.

I therefore express the fervent hope that, for the good of our Nation, this committee will, in its policy deliberations, decide to cast its prestige and influence on the side of giving first priority in tax reduction to reducing discrimination in income-tax rates. A feasible, practical plan for doing this is outlined in my paper filed with this committee.

Most important to your deliberations will be the interpretation given to data included and incorporated by references in the record before you, specifically:

1. The Musgrave paper on comparative tax burdens;
2. The Ruttenberg paper, in its treatment of tax significance of capital productivity; and
3. The several references to the book Effects of Taxation—Investment by Individuals, by J. Keith Butters and associates.

At the appropriate points in discussion, I am prepared to offer, for your consideration and inclusion in the record, material which throws new light on the problem of comparative tax burdens and warrants a decidedly different interpretation than has been given to the Musgrave paper; which shows that the conclusion drawn by Mr. Ruttenberg is diametrically opposite to the conclusion actually justified by the statistical facts he cites; and which shows that the conclusions of the

Butters' book present a badly distorted and inadequate picture of the effects of taxation on the supply of venture capital.

My concluding point therefore is the fact that data dealing with the impact of taxes can be so erroneously interpreted provides concrete evidence that a tax system dedicated to inequality in treatment must by its nature be capricious and arbitrary, as well as harmful to the vital forces of economic progress.

Mr. MILLS. Mr. Davidson, is it your desire that these two charts attached to your statement be included in this record?

Mr. DAVIDSON. Yes; they actually already are in the printed record so they do not need to be reproduced at this point if you don't want to.

Mr. MILLS. It is up to you.

Mr. DAVIDSON. It would help for anyone reading the record.

Mr. MILLS. Without objection, they will be included in this record.

(The documents are as follows:)

DOUBLE PROGRESSION

It is worth noting that the Federal income tax, and any income tax which uses both exemptions and progressive rates, is doubly progressive, when measured against total taxpayer income. To make this point specific, if there were only a 20-percent flat rate of income tax, with present deductions and exemptions, a family of 4 with a $3,000 income would pay 2 percent in Federal income tax; with $5,000 income, 8.4 percent in tax; with $10,000 in income, 13.2 percent in tax: with $25,000 in income, 16.1 percent in tax. Actually, the progressive trend shown in any statement of comparative tax burdens, up to $10,000 of taxable income, is mostly derived from exemption-deduction progression rather than rate progression.

Before exemptions and deductions	A family of 4 taxable income after exemptions and 10 percent in deductions	Tax at 20 percent	Percent of tax to income before exemptions
$3,000	$600	$60	2.0
$5,000	2,600	420	8.4
$10,000	7,600	1,320	11.2
$25,000	22,600	4,020	16.1

TAX IMPLICATIONS OF CAPITAL PRODUCTIVITY

Mr. Ruttenberg, in taking a stand against relief from the discriminatory income tax rates, and in favor of a further narrowing of the base of the individual tax, has firmly anchored his case to the rising productivity of capital. If he is wrong in his interpretation of the tax significance of certain statistical studies which show that the productivity of capital has been rising for some years, his case not only falls apart, but actually lends tremendous weight to the opposite conclusion that first priority in tax reduction should be given to reducing the rates which harass economic activity and block the accumulation and use of capital saving.

It is readily demonstrable that he is wrong. Greater capital productivity is an indication of capital scarcity, not of capital abundance.

Instead of evidencing a declining need for capital, the data he uses provide the most concrete evidence of a growing scarcity of capital. The only logical conclusion that can be drawn from the data is that the removal of tax obstruction to capital formation becomes a more important objective of policy.

Mr. Chairman, what I have said is based on another analytical paper, this time rather brief, prepared by George Hagedorn. It is of such dramatic significance to the proper resolution of the issue before this committee, that I believe it would be worthwhile at this time to read it in its entirety. However, I re-

spectfully ask that it be included in the record at this point and, if you do not wish it read in its entirety, I would like the privilege of skimming through it.

SHORTCOMINGS OF EFFECTS OF TAXATION—INVESTMENT BY INDIVIDUALS, BY J. KEITH BUTTERS AND ASSOCIATES

In the book, Effects of Taxation—Investment by Individuals, by J. Keith Butters and associates, the authors considered the effect of tax rates on venture capital and investment, and reached the conclusion that the repressive effect of taxes on the willingness of investors to hold equities has been not very pronounced.

Some of the more obvious shortcomings of this work were reviewed in the NAM publication, Taxes and Venture Capital, also prepared by Mr. Hagedorn, which I have here and respectfully ask that it be included in the record.

The most glaring misconception in this book is the assumption throughout that capital gains are additional income which is available for new investment in business. It is true, of course, that an individual, when he sells an asset, can use the proceeds after tax to reinvest But the person who buys this asset must pay a greater number of dollars than the seller realizes after tax. The net effect of the transaction therefore is to reduce the amount of investing capacity at existing price levels. Net additions to investing capacity come from savings out of current income, and not from switching current investments.

Additional points made by Mr. Hagedorn in his review of the Butters' book are as follows:

(1) The sample survey of "active investors" is seriously biased in the direction of showing upper-bracket individuals too favorable toward venturesome investments.

(2) The study does not include any investigation of business needs for venture capital, which could be used as a criterion in judging the seriousness of tax effects on the supply of venture capital.

(3) The information collected on individual attitudes toward equity investments fails to take account of the fact that the effects of taxation in creating a venture capital shortage have been discounted on the market.

(4) The basic investment objectives of individuals are assumed in the study to be inherent and unaffected by taxes. The result is to conceal any effects taxation may have in changing investment objectives.

COMPARATIVE TAX BURDENS

I would first like to note that some of the interpretations of the Musgrave data tend to overlook the real significance of his findings. In placing excessive emphasis on the moderate regressivity which he shows at the State and local level, the steep progressivity of the Federal system, and the lesser but still great progressivity of the total tax system, has been obscured.

After all, his figures do show an increase in effective tax burden at the Federal level from 12.1 percent in the $0 to $2,000 group to 32.1 percent for the over $10,000 group, and for all government from 22.8 percent to 30.5 percent.

Nevertheless, the Musgrave data do reflect two fundamental defects in analytical procedure which give rise both to his finding of regressivity at the State-local level, and his understatement of the swift rise of progressivity at the Federal level.

The first defect is in his grouping of all consumer units, families of all sizes and single persons, in one statistical tabulation. This procedure ignores the fact that the Federal income tax is specifically designed to weigh more lightly on a large family than on a single individual. For example, a single man with an income of $3,000 will pay nearly twice the income tax of a married man with two children who has an income of $4,000.

It would be absurd to cite this result as an instance of "regressivity" since it is by deliberate intention of the Congress—an intention which certainly is not to create a regressive tax system. Yet the Musgrave results do just this—the lower income classes contain a large proportion of single persons whereas the higher income classes contain very few.

The second defect of the Musgrave procedure and data is the computation of the burden of State and local taxes without regard to the prior payment of

Federal income tax, a tax which we all know has a first claim on everyone's income. A person is not in position to pay the various nonincome taxes at the State-local level until he has satisfied his Federal income tax obligations. It is therefore meaningless to measure the burden of State-local taxes against income which includes amounts already taken in Federal income taxes. The amount a person has after income tax is his disposable income, and this is all that he can use for any purpose, including payment of State and local taxes. To take an extreme illustration, a person who paid 90 percent of his income in Federal income tax could not possibly pay more than 10 percent of his income in State-local taxes.

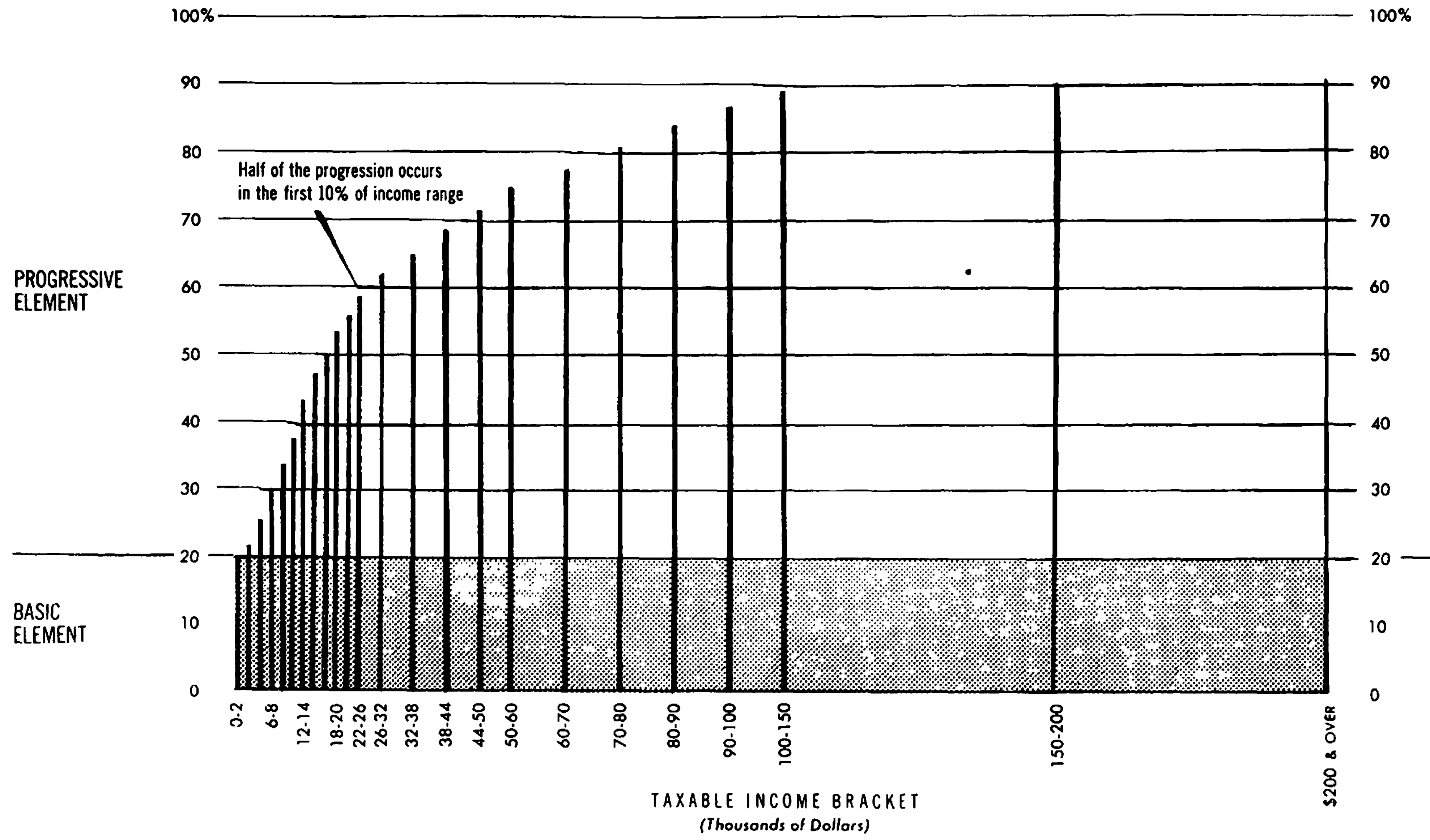
The result of these defects in Professor Musgrave's paper is not just to understate the progressivity of the Federal tax system, or of the total tax system, but is his erroneous finding of regressivity in the State-local system.

When these defects in analytical procedure are avoided, the State-local tax system is found to be actually mildly progressive, with the effective burden of taxes ranging from 8.6 percent of disposable income at the $3,000 level upward to 10.7 percent at the $15,000 level.

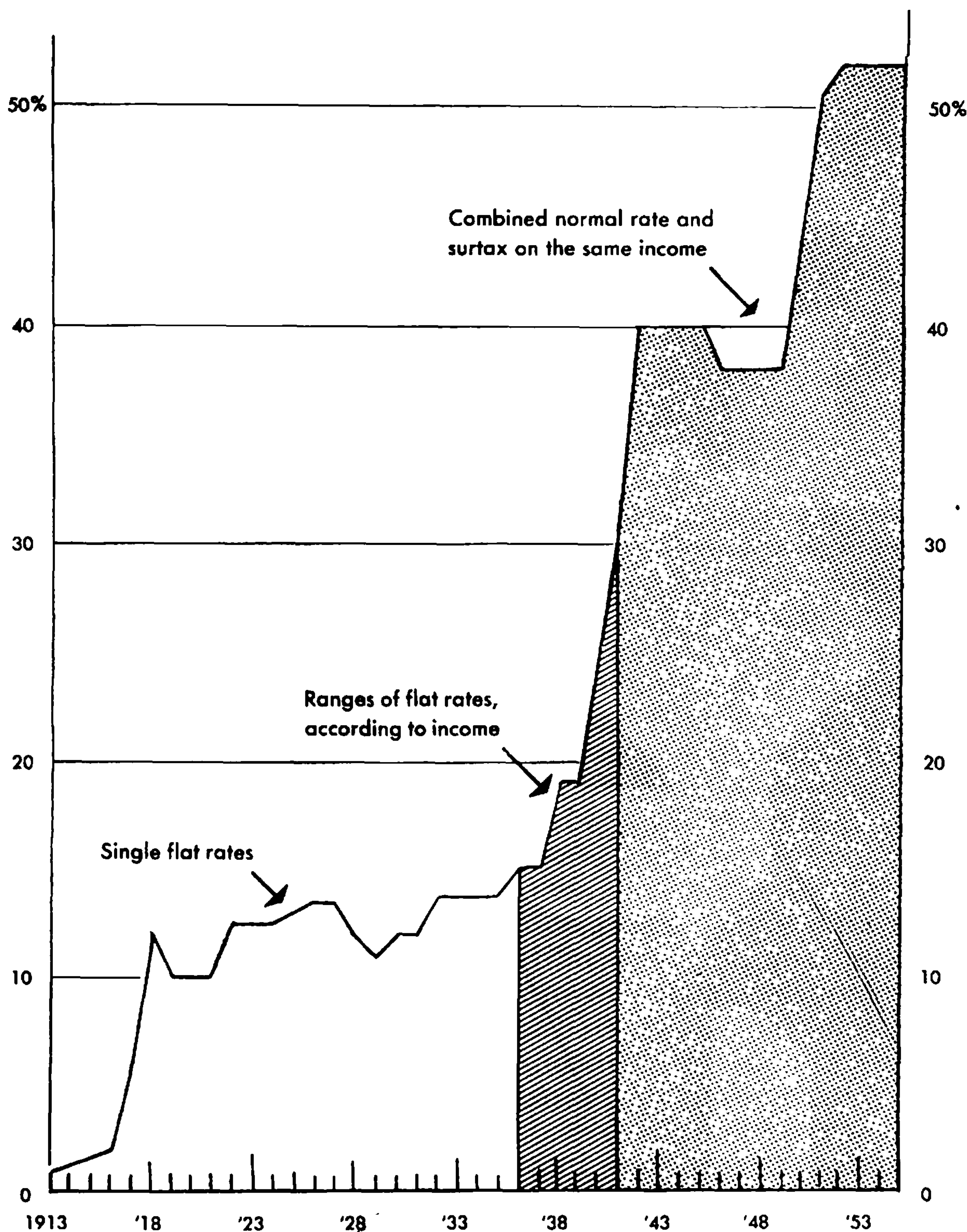
These points and conclusions come from A Study of Family Tax Burdens by Income Levels, prepared by the research department of the NAM. For reasons explained therein, it is only a statistical oddity having nothing to do with regressivity, that a $2,000 income is shown to have a slighly higher State-local tax burden than a $3,000 income.

I respectfully ask that this paper be included in the printed record of these hearings.

Rate Jumps by Income Bracket



Top Rates of Corporate Income Tax



Excludes the misnamed "Excess Profits Tax" of World Wars I and II and the Korean conflict.

Mr. MILLS. Our next panelist is Mr. William Fellner, professor of economics, Yale University.

Mr. Fellner, you are recognized.

Mr. FELLNER. Mr. Chairman, in most of the current discussion of impending tax changes the economy is visualized as moving fairly smoothly on a growth path, with reasonably full use of its resources and without inflation.

However, at given tax rates, the growth of the national income is expected to result in gradually increasing tax revenues relative to

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fiscal expenditures, and this is expected to lead to a deflationary pressure.

Tax revenues may increase by as much as three to four billions each year, and while there will be an increasing need for nondefense expenditures on roads, education, public helath, and so forth, these needs will not be growing at the rate at which tax revenues would be raising at unchanging tax rates. Thus, we will reduce tax rates in order to prevent an insufficiency of effective demand, that is, of consumer demand plus investment demand.

At first, I shall develop my conclusions from this common assumption. Subsequently, I shall make a few remarks on how the conclusions change if we modify the initial assumption concerning business conditions. In this case the conclusions change appreciably.

On my initial assumption, a reduction of the 52 percent corporate income tax rate probably has more merit than any other type of tax reduction. But I would not suggest committing ourselves to this reduction right now for the fiscal year 1956–57. A decision on whether the economy can stand an additional small anti-inflationary fiscal impact in 1956–57 should, I think be postponed until somewhat later, because it will always be easy to reduce taxes while it is difficult to raise them.

The conclusion concerning the desirability of reducing the corporate income-tax rate is derived by weighing the pros and cons of various types of tax reduction.

A reduction of individual income-tax rates would, of course, possess great merit, but I believe that on the initial assumption which I have described these merits are outweighed by those of a reduction of corporate income-tax rates.

The main merit of individual income-tax reductions, especially of reductions in the low-income brackets, is that the increase in effective demand per dollar of tax reduction has a relatively well predictable magnitude. The effect is likely to be large per dollar of tax reduction because a very high proportion of the tax saving is likely to go into additional consumption expenditure.

Merely a much smaller proportion of the tax saving from corporate-tax reductions can be expected to go into additional consumption directly. Much of the rise in consumption comes here indirectly, with a small lag, as a result of increased investment, of increased productivity and of rising wages.

A reduction of corporate income-tax rates induces not merely additional consumption expenditure. It induces also additional investment expenditure, partly because corporations are left with more internal funds and partly because an increase in prospective profit rates, after taxes, results in increased willingness to accept business risks.

The magnitude of this investment-raising effect per dollar of tax reduction is less predictable than is the magnitude of the consumption-raising effect of low-bracket individual tax reductions.

Therefore, if we want to play safe in our effort to increase effective demand by a specific magnitude, we may have to reduce corporate income taxes by somewhat more than the amount by which low-bracket individual income-tax burdens would have to be reduced. We may have to lower corporate income-tax revenues for any given level of the national income by between 20 and 50 percent more.

This seems safe enough. If it then turns out that we have underestimated the stimulus provided by the corporate-tax reductions, we may have to rely to a somewhat greater extent on Federal Reserve restraints to prevent inflation.

Admittedly, it is a disadvantage of corporate income-tax reductions that the magnitude of their effect on private spending, per dollar of tax reduction, is less predictable than that of some other tax reductions.

This disadvantage is, I think, outweighed by an important advantage. The additional output called forth by corporate income-tax reductions consists of capital formation to a greater extent, and of consumer goods to a smaller extent, than does the additional output called forth by other tax reductions.

This means that we are likely to get higher growth rates if we reduce the corporate income tax. At present, net capital formation accounts for a somewhat smaller proportion of total output than was the case during the 1920's or in earlier decades. There is room for some increase in capital formation relative to other constituents of the total output.

Moreover, increased capital formation and an increased capital stock per unit of labor are likely to benefit the low-income groups by more than the equivalent of what they could obtain by tax reductions.

Higher labor productivity expresses itself in higher real wage rates, and it takes merely a short time to obtain a greater increase in welfare by this method than by exempting individuals from tax payments amounting to a very small percentage of their incomes.

Hence, I would argue that a growth-oriented attitude calls here for placing the main emphasis on reducing the 52 percent corporate income tax.

The assumption underlying my analysis was that of well-balanced economic conditions which threaten to become gradually unbalanced in the deflationary direction because of the gradual rise of tax revenues relative to fiscal expenditures.

If we change the assumptions, the conclusions, too, become quite different.

For example, if the initial condition were that of more or less acute cyclical contraction, then we should place at least as much emphasis on reducing the tax burden of the consumer as on reducing corporate taxes.

In acute contraction, the incentive effect of corporate-tax reductions is weak until the contraction of consumer demand is checked.

If, on the other hand, the initial condition is that of inflationary pressure which the Federal Reserve finds difficult to control, then tax reductions should be postponed even if a budgetary surplus is gradually accumulating.

I think it might be wise to postpone this decision until some time in 1956. It is not really clear whether we will or will not be facing inflationary pressures which the Federal Reserve will find difficult to control.

Mr. Mills. Before we proceed further, let me clarify one matter.

Mr. Davidson, I did not understand that you had other material than these two charts which were attached to your original statement.

Was it your desire that this additional material, which is now in my hand, also be included as a part of your opening statement?

Mr. DAVIDSON. I would be very grateful if it could be, Mr. Chairman. I had intended to offer it at the appropriate place in the discussion. If you will accept it for the record I would be very grateful.

Mr. MILLS. Would there be objection to the inclusion of this additional material following Mr. Davidson's opening statement?

(No response.)

Mr. MILLS. The Chair hears none. It will be included.

Our next panelist is Mr. Stanley H. Ruttenberg, director of research and education, CIO—should I say, AFL–CIO?

Mr. RUTTENBERG. Let me explain that, if you will, Mr. Chairman. At the time my paper was prepared and submitted and printed in the record, I was director of education and research of the CIO.

As you all know, this week, the CIO and AFL have been merging at a convention in New York, and at the conclusion of that convention, beginning next week I shall be the director of research for the AFL–CIO.

What I am this week I am not quite sure, but I speak here, I think, as the economist for the CIO. And I am not so sure whether my views—I think they are but I am not so sure they are, the views of the joint CIO–AFL.

That we will find out after our convention adopts a resolution.

Might I say before I read my summary statement that I would like to, if possible, Mr. Chairman, reserve the right to submit for the record some material dealing with the analysis which Mr. Davidson has submitted.

Mr. MILLS. Without objection, it will be included immediately following your statement.

Mr. RUTTENBERG. It is my firm conviction that the Government's tax policy, should place its major emphasis on the need for a continuing expansion of consumer markets. This view is based in part, on considerations of equity. But it is also based on our view of the American economic system and its requirements in the middle of the 20th century.

As I see it, the national economy today is quite different from what it was some 50 or 90 years ago, and those who legislate and administer our tax policy should recognize these changes. Tax policy should be based on the national economy as it is today, not on reports of how it functioned in the distant past.

The American economy has been changing from the private-capital-formation centered economy of the post-Civil War decades to one that is based to an increasing degree on personal consumption and consumer markets. The rise of the consumer durable goods industries in the past 30-odd years— and their dependence on mass markets—seems to me to be an indication of the growing economic importance of consumer activities. An economy in which the basic steel industry, for example, will sell this year approximately 50 percent of its output for the production of automobiles, other consumer durables and housing is quite different from the national economy of 50 to 90 years ago, in which the railroads were a major steel consumer.

The post-World War II record, as I see it, indicates that the dollar level of business investment in new plant and equipment rests, not so much on business tax rates, as on general market conditions and on consumer markets, in particular.

Furthermore, technological advances have been changing the relative importance of new plant and equipment expenditures within the national economy. New plant and equipment tends to be labor saving, as over the long-run past.

But since about World War I, new plant and equipment has tended to be capital saving, as well.

Recent studies by Daniel Creamer, Israel Borenstein, John Kendrick all of the National Bureau of Economic Research, and others indicate that the productivity of capital output per unit of plant and equipment has been rising. Output levels have been increasing faster than business investment in fixed capital.

In his study Capital and Output Trends in Manufacturing Industries, 1880–48, Daniel Creamer states: "* * * in the earlier decades an increasing fraction of a dollar of capital was used to produce a dollar of output; in more recent decades a decreasing fraction of a dollar of capital has been sufficient to produce a dollar of output. This is consistent with the interpretation that in the earlier decades capital innovation on balance probably served more to replace other factor inputs than to increase output. More recently, the balance has been in the other direction—capital innovations serve more to increase the efficiency of capital, hence to increase output, than to replace other factor inputs."

Wassily Leontief points out in the September 1952 issue of Scientific American:

> The amount of capital needed for each unit of output has actually been reduced in recent years and the installation of automatic machinery will further reduce it.

Despite the extraordinary rise in the dollar volume of business plant and equipment expenditures since 1946, they have taken a smaller share of the private gross national product than in the 1920's. The rising productivity of fixed capital has been reducing the national economic importance of business investment in new plant and equipment.

In an economy where business investment in new plant and equipment is declining in economic importance—and where consumer markets are a major motivating force—economic policy, generally, and tax policy, in particular, should provide for expanding consumer activities.

The alternatives to such consumer-oriented policies, as I see them, are either a willingness to accept a high and growing level of Government expenditures and intervention in the economy, or an acceptance of long-run stagnation, interspersed with periods of slow growth.

A consumer-oriented tax policy, at the present time, requires an increase in personal income tax exemptions to expand the purchasing power base of consumer markets.

(The analysis information is as follows:)

REPLY OF STANLEY H. RUTTENBERG TO STATEMENT SUBMITTED BY JOHN C. DAVIDSON, IN CRITICISM OF RUTTENBERG'S PAPER

In my paper, The Declining Role of Business Investment in a Growing Economy, I stated—based upon findings of economists at the National Bureau of Economic Research—that to obtain continued economic growth, we now need a lesser percentage amount of capital, because business investment has become, since World War I, capital saving, as well as labor saving. From these basic findings, I concluded that:

(1) Despite the very high levels of business investment in new plant and equipment in recent years, such investment has accounted for a smaller percentage of private gross national product than in previous prosperous periods, as indicated by the Department of Commerce publication, Markets After Defense Expansion.

(2) There has been a significant shift in the nature of the national economy from one that was private capital formation centered in prior periods to one that has become increasingly dependent on the role of personal consumption; high and rising levels of business investment depend, in the long run, on the actual and anticipated expansion of consumer markets.

(3) Tax policy must recognize this change in the nature of the national economy and greater emphasis must be placed on encouraging consumer spending on goods, services, and housing.

(4) The alternative to consumer-oriented tax and other Government economic policies is increasing reliance on Government expenditures—and on Government intervention in the economy—if economic growth and full employment are to be maintained.

In his reply to these views, Mr. John C. Davidson, of the National Association of Manufacturers, declared: "Greater productivity is an indication of capital scarcity, not of capital abundance. Instead of evidencing a declining need for capital, the data he (Ruttenberg) uses provides the most concrete evidence of a growing scarcity of capital. The only logical conclusion that can be drawn from the data is that the removal of tax obstruction to capital formation becomes a more important objective of policy."

Of course, it would be possible to discuss Mr. Davidson's reply in philosophical terms and to attempt to discover what he means by the term "scarcity." By what criteria has capital been scarce? What are Mr. Davidson's yardsticks for measuring a scarcity, sufficiency, or surplus of available investment funds? But rather than to pursue these questions that can lead us away from a discussion of actual economic developments, I think it would be more fruitful to examine the developments that have taken place.

Business expenditures for new plant and equipment since World War II have been at record high levels. The following figures from the Securities and Exchange Commission and the Department of Commerce are a clear indication of the extraordinarily sharp rise in business outlays for plant and equipment since 1939:

Business expenditures for new plant and equipment

	Billion		Billion
1939	$5.51	1952	$26.49
1946	14.85	1954	26.83
1948	22.06	1955	28.27
1950	20.60	1956 [1]	29.16

[1] First quarter anticipated outlays, at annual rate.

This increase in business expenditures for new plant and equipment was accomplished in a period of high tax rates on both business and personal incomes. Its accomplishment implies to me that there was no scarcity of available investment funds. I see no evidence whatsoever in this post-World War II record of a shortage of funds for investment purposes.

Furthermore, the source of business investment funds indicates to me that business generally did not reach any ultimate limit in the availability of such funds since World War II, despite the high levels of plant and equipment outlays.

As I stated in my paper, the high liquidity of business generally and the fact that it does not rely to any significant degree on equity financing for new investment is a clear indication that investment funds are certainly available. In the years since 1946, some 65 to 80 percent of corporate new plant and equipment outlays have been financed from internal funds. The issuance of net new common and preferred stock has accounted for merely about 5 or 10 percent of corporate plant and equipment outlays since the end of World War II; borrowed funds have accounted for an additional 15 to 20 percent of such investment.

Some of those who have appeared before this committee have expressed concern about a growing scarcity of available investment funds because of the reported small decline in after-tax incomes of the top-income 5 percent of American families, by comparison with the 1920's and previous periods. First, I think we would have to add to their after-tax money incomes the multitude of fringe benefits now received by most corporate executives. And, secondly, there has been the rapid

growth of personal savings in recent years due, in large part, to trade-union action, in the form of insurance, health, and welfare funds, and pension funds. Indeed, there were those who testified before the Senate Banking and Currency Committee's investigation of the stock market that the large sums held by various trust funds and similar institutions were pressing stock prices upward.

Finally, the capital goods equipment industry, itself, apparently knows nothing of the scarcity of available investment funds about which Mr. Davidson speaks. On November 28, 1955, the Machinery and Allied Products Institute issued a statement that declared: "Capital funds available to United States corporations during the next decade appear to be sufficient to sustain a high level of capital expenditures, according to the results of a recent study conducted by the Machinery and Allied Products Institute.

"From this latest study two main conclusions are indicated:

"1. The prospect is for capital funds from internal sources over the next 10 years to run around 95 percent of the projected expenditure requirements (Capital Goods Review No. 22, copy attached), on the basis of a high retained-earnings estimate. Even a low estimate of retained earnings indicates a coverage of 90 percent or better.

"2. Projected capital funds from external sources such as security issues, mortgages, bank loans, and accrued tax liablities appear to be ample to cover the projected deficiency of internal funds. During the decade just closing, funds from these external sources sufficed to offset requirements for working-capital expansion and to leave a balance of $37 billion for fixed-asset purposes—an amount which substantially exceeds the projected $26 billion external capital requirements in the decade ahead."

The argument posed by Mr. Davidson does not appear to hold up on investigation. There is no evidence of a shortage of business funds and there does not appear to be any such shortage in sight.

I believe that a high and rising level of business investment in plant and equipment is important if we are to sustain economic growth and high levels of employment. But the required high levels of business investment depend, to an increasing extent, on the state of consumer markets, if we are not to rely upon a continually growing economic role of Government expenditures.

The rise in the productivity of business investment in plant and equipment means, as I see it, that continued high and rising levels of such investment will not increase its share of the private gross national product, since output per dollar of business investment is rising. Indeed, the business investment share of private gross national product has slipped somewhat below the level of the 1920's and may continue to slip in the decade ahead, despite high levels of plant and equipment outlays. Under these conditions, as I see it, the alternatives are either an increasing emphasis on consumer spending or on Government expenditures. Since I would prefer to see the necessary adjustments made within the economy's private sector, I have suggested that Government economic policies generally—and tax policy, in particular—place their emphasis on the need for expanding consumer purchasing power and expenditures.

Mr. MILLS. Our next panelist is Mr. Paul Samuelson, professor of economics, Massachusetts Institute of Technology.

Mr. SAMUELSON. Mr. Chairman, members of the subcommittee, I come before you not as an expert in public finance. I have often aspired to be one, but like Dr. Samuel Johnson's friend who aspired to be a philosopher but found that cheerfulness kept breaking in I, too, have had my desire to be a public finance expert frustrated by the fact that cheerfulness kept breaking in.

My testimony here is extremely optimistic, and if I may say so, may be in contrast to some of the testimony that you have received.

As an economic analyst, however, I agree with Mr. Clemenceau's doctrine that public finance is too important to leave to the public finance experts, and I think that a little auditing by the economic theorists may occasionally be in season.

My doctrine, as I say, is extremely optimistic. I might begin by stating my opinion that the postwar American economy has been, and

is, in very good shape. All of the qualitative and quantitative indicators of the last dozen years I think will bear that out. I would go on to say that the existing tax structure is in its broad features satisfactory, provided the American people want the existing tax structure, and some millions of votes at periodic intervals suggest they do. The economic theorists can assure the American people that their goals are not inconsistent with sound economic doctrine.

Now, more specifically, let me mention five possible goals of tax policy. First, we all want high rates of growth. You know if you ask consumers the question, "What would make you happy?" they always say, "More."

Each man thinks if he had 20 percent higher income he would be really happy, and so many economists studying the problem of economic growth act as if there is no rate of economic growth which is optimal; a little bit more than we have been having, say a 30 percent higher rate than we have been having, would be very good.

It would be very good if purchased at no cost.

A second conflicting goal, however, is that we all want high current consumption levels. Everyone knows of men who die rich, because they have lived too poorly, and the same is true of a society. A society that grows very rapidly and never pauses to reap the harvest in the form of consumption, is in danger of having confused means and ends.

Thirdly, we are all interested in moderating cyclical stability and the other insecurities that plague American families.

Fourthly, there is the goal of equity.

This is a problem of ethics, it is a problem of fairness.

It is not a problem of scientific technical economics. No higher degrees of mine nor of my colleagues entitles us to speak out with louder voice on this question than that of the man on the street, than that of any other citizen in our democracy.

Nevertheless, that doesn't mean that equity is not an important goal, and some would say in the end the most important goal of all.

A fifth and final goal is that we are all interested in efficiency in production.

We are interested in minimizing distortions. Perhaps more exactly I should point out that this fifth goal is not truly an end in itself; it is a means; it is a way of enabling us to have more of the others.

Well, I have listed these five goals. We all want more of every one of them. Obviously, we can't have as much as we want of each. It is necessary to compromise one for the other.

The higher our rate of capital formation, the higher our rate of abstinence from consumption, the lower must, other things equal, be our current level of consumption, and so it goes.

Now, I can't pretend as an economic expert to play the role of Solomon and tell you what is the proper compromise between these different goals. That, in my interpretation, is an ethical and political question that Congressmen and the American democracy must decide. Here is where my cheerfulness breaks in: on the basis of some years of careful study of economic analysis, new and old, I have come to the view that economic analysis itself is quite neutral with respect to the realization of these goals.

We can be optimistic. A democratic people can have the proper mix of these things that it desires. There is no technical reason known to the statisticians, to the economist, to the realist, that will thwart this desire.

So, let me conclude with two statements. One, I wish to reiterate that by the proper choice of monetary and fiscal policy we as the artists, mixing the colors of our palette, can have the capital formation and rate of current consumption that we desire. That is the first part of my message, and I think it is rather conventional; but the second part of my message I think is too little stressed these days.

It would be a misunderstanding of my viewpoint if you were to think that we can have a high rate of capital growth only if we sacrifice equity; only if we bias our tax system in the direction of incentive and sacrifice equity.

On the contrary, and this I consider to be perhaps in an unpretentious and prosaic way, slightly novel, in comparison with other testimony that you have here—I would like to state the following doctrines, perhaps a little paradoxical: A community can have full employment, and it can at the same time have the rate of capital formation it wants, and it can accomplish all this compatibly with the degree of income redistributing taxation it ethically desires.

I am prepared later if you wish to expand upon the reasons why I hold this, if you ask me to.

Mr. MILLS. Does that complete your statement?

Mr. SAMUELSON. Yes, sir.

Mr. MILLS. Our next panelist is Mr. Emerson B. Schmidt, director, economic research department, Chamber of Commerce of the United States, Washington, D. C.

Mr. Schmidt, you are recognized.

Mr. SCHMIDT. Mr. Chairman and members of the subcommittee, because of the currently high levels of business activity many panelists present arguments for maintaining the present levels of taxation.

Obviously this diagnosis is based on a forecast. By the time Congress gets around to acting on tax policy, as Professor Fellner so well pointed out, it is quite possible that the recent rates of growth will be less evident.

If our concern is with future growth it is obvious that there must be both the incentive to invest and the ability to save.

Incentive rests on prospective returns and risks of losing the capital. Capacity to invest rests on the ability to save and borrow.

However, one witness before this subcommittee made an attempt to show a declining importance of investment, and I quote:

> The American economy has been changing from the private-capital-formation-centered economy of post-Civil War decades to one that is based to an increasing degree on personal consumption and consumer markets * * *. I do believe, however, that business investment in the American economy is no longer the key motivating factor * * *. Business investment, as I see it, has been declining somewhat from the previous key role in our national economic development and is, to a growing extent, dependent on the actual and anticipated extent of consumer markets.

The witness before the subcommittee goes on to argue that business investment has increasingly become both capital saving as well as labor saving. As a result total output has been rising at a more rapid rate than business investment in new plant and equipment. From this

he draws the conclusion that investment in new plant and equipment is of increasingly reduced importance.

Actually, the opposite conclusion would appear to be more valid. Employment has also been growing at a slower rate than total output. Does it logically follow that labor "has been declining somewhat from the previous key role in our national economic development?"

Obviously not. On the contrary, both labor and capital are now more productive.

To be sure, it takes less labor and less capital to produce a given level of output. If we wish to expand per capita output, however, we need to create jobs for all and increase investment per job. Investment per new job now runs to $13,000.

But simply because capital is more productive, the witness says we now can reduce emphasis on new investment. This seems to be a complete non sequitur. We still have vast numbers of people who would like to live better than they do and virtually the only way to achieve that goal is to have more and better investment per worker under capable management hands.

Furthermore, very few economists, if any, agree with the witness that our economy is no longer capital-formation-oriented. Alvin Hansen makes the opposite, the key point in his testimony.

Dr. Neil H. Jacoby, formerly a member of the President's Council of Economic Advisers, stated:

> Yet there is no doubt that the dollars spent by business on plant and equipment were a more important determinant of the course of economic events than any equivalent amount of other expenditure. Plant and equipment expenditures are the heart of the process of economic growth. They hold the key to the business cycle—that rhythm of boom and depression which has caused our country great difficulty in the past.

Again Dr. Jacoby said:

> Dollars spent—or unspent—on capital goods are "high-powered" dollars, having a manifold influence on total demand and therefore on the health of the economy.

The Machinery and Allied Products Institute recently made a projection of probable capital needs for the future as indicated in the accompanying tabulation.

This shows a 50 percent increase in capital needs in a single decade over current rates of investment. These figures do not include the need for working capital to finance inventories, payrolls and other operating costs.

Projected plant and equipment requirements

[Billions of dollars at 1953 prices]

Year	Amount	Year	Amount
1955	32.0	1961	41.9
1956	33.9	1962	43.5
1957	35.0	1963	45.1
1958	37.2	1964	46.7
1959	38.8	1965	48.4
1960	40.4		

Source: Capital Goods Review No. 24, November 1955, Machinery and Allied Products Institute, Washington.

Roughly from $32 billion today to over $48 billion in 1965. These figures, of course, do not include the need for working capital.

Democracies throughout the Western World have a constant struggle to get enough capital. Even in the depression of the 1930's, we did not have oversaving or excessive capital formation. Our economy was not mature; rather, a number of maladjustments were so all-pervasive that recovery could not take place.

In this respect, Prof. David McCord Wright had the following to say:

But investment is the basic problem. Measures to stabilize consumption (public works, unbalanced budgets, etc.) may indeed keep the slump from getting worse. But they are after all mere first aid; that is, if we are not just trying to smuggle socialism in by the back door. Until growth once more gets underway and with it new investment, there cannot be a spontaneous recovery of the private economy.

And I think somewhat contrary to what Professor Samuelson just said, it has a very close bearing on the philosophic problem he raised.

The Economist (London) had the following to say:

It is all too easy for a democratic universal suffrage community to allow capital formation to be pushed to the wall. * * * Capital creation may be necessary; but there are very few votes in it. Yet the penalties for neglecting it, though they may take some time to mature, will in the end be inexorable. An installment is being experienced now. But if underinvestment continues much longer, then it may be wholly impossible to rescue the British economy. * * *

We do not want to follow the path of the British economy.

Many of the panelists in these hearings lament the erosion of the tax base, the growth of real or alleged loopholes, escapes, special exemptions, exceptions, preferential treatment and leakages.

Some of them scarcely hide their views favoring the reversal of this trend. But most of them appeared to ignore the fact that the high income-tax rates, widely regarded as confiscatory, are the seedbed from which many of these trends developed and are likely to continue to grow—we taxpayers being the kind of people that we are and the pressure on the Congressman to grant relief being what it is.

Does this not suggest, again, that we are placing undue reliance on income taxation? Would we not be well advised to move somewhat more into some form of excise taxation?

The fabulous expense to the Internal Revenue Service of administering our complicated tax system and the expense to which the taxpayer is put in figuring out his tax liability and ways and means of minimizing his tax burden, likewise, cannot be ignored.

What does this suggest for tax policy? With a large population growth, coupled with the fact that we will soon be adding an average of a million new workers to the labor force per year, there will be need for very large new investment funds.

Existing individual businesses may continue to generate a large portion of the needed funds through depreciation and amortization allowance and retained earnings.

But, our present tax system, it is widely believed, tends to favor the successful existing enterprises and makes it more difficult for newcomers to gain a foothold.

If we are to have a high birthrate for new enterprises of a venturesome and foresighted nature, however, it is extremely important to have an income-tax system that does not tap an unduly large proportion of equity funds.

Since the bulk of venture capital, other than that generated by existing businesses, historically comes from the middle- and upper-income sources, considerable emphasis should be given to a tax cut at those levels, as well as a cut across the board, provided the budget permits and we are not in an inflationary phase.

Indeed, the wartime-created extreme graduation of the individual income tax should be reexamined with a view to encouraging risk capital by lowering the middle and upper levels.

If, after such a cut, circumstances suggest a further tax reduction, the corporate rate ought to be allowed to return to the pre-Korean level of 47 percent, and certainly in no case above 50 percent. Following such a cut, attempts ought to be made to reduce some of the emergency discriminatory excise taxes and, if necessary, broaden somewhat the excise-tax basis.

However, if we are in an inflationary boom, first consideration should be given to utilizing an appropriate part of the revenue surplus for reducing our national debt.

Mr. MILLS. Our next panelist is Mr. Herbert Stein, associate director of research, Committee for Economic Development, Washington, D. C.

Mr. Stein, you are recognized.

Mr. STEIN. Mr. Chairman and members of the subcommittee, in the short time allotted to me I can probably best explain my views on the consumption and investment question by discussing a particular situation: This is a hypothetical situation, but it may turn out to be fairly close to the situation we face in the next few months.

Suppose that we start with high employment and without more inflationary pressure than can be kept under control by monetary restraints. Suppose, also, that the cash budget is in balance and that we expect total Federal expenditures to be approximately constant.

As we look ahead to next year we see the prospect of a larger labor force and greater productivity. If high employment is maintained, there will be higher individual incomes, higher corporate profits, and higher sales. As a result, the tax base will rise and tax revenues will rise if tax rates are kept unchanged. With present tax rates, this increase in revenues from one year to the next might be around three to four billion dollars.

In this situation, and with Federal expenditures constant, the possibility of a tax reduction arises. It will arise under either of two theories: First, there would be a budget surplus if tax rates were not cut, so the budget-balancing principle would permit or require a tax cut.

Second, with output rising and Government spending unchanged, there will be more goods and services available for private purchase.

But if Government revenues are allowed to rise, the income that private individuals and businesses will have available to spend will not rise as much as the product available for them to buy.

In the absence of clear evidence of strong inflationary pressure, it is sound policy to cut taxes and allow private after-tax income to rise as fast as output available for private purchase.

At this point we encounter the question that is the subject of today's consideration; namely, which taxes to cut. There will be many views on this question, but only two are directly relevant to the consumption versus investment focus of today's hearings.

One view will be that in order to promote economic growth emphasis in tax reduction should be given to those moves that will increase saving and increase the after-tax return on investment.

The other view is that the most important step toward promoting investment is to expand consumer demand so that there will be a larger market for output from expanded productive capacity. On this view more emphasis would be placed on tax reductions that would promote consumption.

This difference of opinion is likely to take the form of a difference of opinion between reducing corporate taxes and upper-bracket income taxes on the one hand and, for example, raising income-tax exemptions on the other hand.

In my opinion the second view is incorrect.

I agree that the state of the market for the output of productive capacity is an important factor in determining the rate of new investment. There is likely to be more new investment if existing capacity is fully utilized than if it is not.

But the market that is relevant here is the total market—including not only the consumers market, but also the market for investment goods and for sales to Government.

We can and do expand productive capacity in order to produce more investment goods which are used to expand productive capacity in order to produce more investment goods. We expand steel-production capacity in order to produce steel used in the production of machinery plants which produce machinery used in steel mills.

We simply do not know whether the total market will be smaller or greater if we reduce the corporate tax and upper-bracket income taxes than if we raise personal income-tax exemptions—to take these alternatives as illustrating the issue. The effect of increasing saving and increasing the prospective after-tax return on investment may be a large increase in total demand or a small increase.

But I believe that however uncertain the relative effects of the tax reductions themselves may be, we are able to say something about the effects of the tax reductions when combined with appropriate monetary policy. If it were true, or should turn out to be true, that an investment-oriented tax reduction did not by itself give us an adequate total demand for goods, total demand could be brought up to the desired level by relaxing monetary restraints or promoting monetary ease.

By a combined monetary and tax program we can get both the investment-stimulating effects of more saving and better prospects for net return from capital and the investment-stimulating effects of a high level of total demand.

This does not mean that all tax reduction should be confined to the corporate income tax and upper brackets of the individual income tax. Tax policy and economic policy generally have other objectives in addition to promoting investment and economic growth. These other objectives call for a more broadly shared tax reduction, including all rates of individual income tax and, if possible, some steps in the excise field as well.

But in terms of the question asked this panel, we should not be deterred from reducing taxes that repress investment by fear that the result will be inadequate markets for the product of investment.

Mr. Mills. We thank each of you for your appearance this morning, and for the information you have given the subcommittee in the compendium.

This morning I will ask Senator Douglas to begin the interrogation.

Senator Douglas. I take it that what Mr. Davidson, Mr. Fellner, Mr. Schmidt, and Mr. Stein advocate is a reduction for the budget year of 1956–57 in either or both of the corporate tax or in the upper and middle upper brackets of the individual income tax.

It take it that is what these gentlemen are advocating and I would like to raise this question: Assuming current levels, or at current levels of activity, how much of a net reduction in revenues are they proposing?

Is it a reduction of 3 or 4 billions which the CED advocated in its bulletin of 2 days ago, or is it the intent to get a greater tax reduction than that and either cut expenditures or shift the burden through an increase in excise taxes to other classes in the community?

I will ask Mr. Davidson to answer the question.

Mr. Davidson. I think the answer to the first part of your question, Senator Dougles, is that the NAM proposal as to what should be done in 1956 is related to what we think should be done over the next 5 years, that we should have this orderly, gradual approach to getting rid of the high and discriminatory rates.

Actually, if we average out in 1956 what we are talking about over 5 years, we would propose the use of only about $2 billion in available budget margins for tax reduction of the kind on which we place a great deal of emphasis.

In our program, we place second emphasis on the reduction of the first bracket rate of the individual tax.

We consider that taxpayers who pay only that tax are not discriminated against, but we do think that the first bracket rate of 20 percent is entirely too high for the long-range good of the Nation and of course it is a reflection of the relatively narrow base, $120 billion of taxable base as compared to $300 billion in actual income.

If there should be budget margin over and above the $200 billion we are thinking about on an annual basis in the 5-year plan we feel strongly it should be used to reduce the first bracket rate of income tax.

Senator Douglas. As I understand the proposal of CED which I read last night, they believe that the normal growth in revenues for 1956–57 would produce a surplus in the cash budget of approximately $3 to $4 billions.

Therefore, they propose a reduction of that amount. What you are saying is that if that should happen, you would only want to have a reduction in loans of $2 billion and use the other $1 or $2 billions for reduction in the debt?

Mr. Davidson. Reduction in the first-bracket rate.

Senator Douglas. You are not proposing to redistribute the burden? You are not, then, proposing at this time to redistribute the burden as between income groups; are you?

Mr. Davidson. Not at this time nor at any time, Senator.

We do have a recommendation in that area but it is only to equalize and make equitable the excise-tax structure and not to increase the burden of excise taxes on the economy.

Senator DOUGLAS. Is your sales tax merely intended to produce the same total which is now obtained from excise taxes?

Mr. DAVIDSON. That is right, sir.

Senator DOUGLAS. That is not to increase the total of Federal excise and sales taxes but to redistribute the amounts from excise taxes?

Mr. DAVIDSON. That is right.

I might add, Senator, that our studies show that if the excise-tax system were equalized the average burden by income groups would be about the same as the present selective system and the net result of equalizing the excise- tax structure would be to spread the burden fairly among competing producers rather than have any adverse effect on consumers as such.

Senator DOUGLAS. Subject to correction, I believe the total amount received from excises now is about $9.3 billion?

Mr. DAVIDSON. That includes alcoholic beverages and tobacco.

Senator DOUGLAS. You are proposing to redistribute that $9.3 billion but not increase it by transfers from what otherwise would be receipts from corporate and income taxes?

Mr. DAVIDSON. That is quite right, Senator, in the sense that that 9.5 is made up of $5 billion of alcoholic beverages and tobacco taxes and $4.5 billion of general excise.

Our proposal is directed to the general excises although we think the alcohol beverage and tobacco rates are too high.

Senator DOUGLAS. You would not alter the taxes on beverage and alcohol?

Mr. DAVIDSON. We would not bring them into the framework of the general excise; no, sir.

Senator DOUGLAS. Your proposal is to redistribute this burden of $4 billion?

Mr. DAVIDSON. That is right.

Senator DOUGLAS. I am very glad to be corrected on that, because I thought that at least in previous positions of the NAM that you were advocating that some of the tax revenues now obtained from income taxes, and corporate taxes, would be shifted to a general system of excise tax.

Mr. DAVIDSON. No, sir.

Senator DOUGLAS. I want to thank you very much for making that clear.

Mr. DAVIDSON. I might say the history of that tax is different. It goes back many years.

During the last 4 or 5 years our proposal has been one of purely maintaining the revenue, Senator.

Senator DOUGLAS. That is very interesting.

Mr. Schmidt, are you proposing that a total reduction should be greater than the expected increase in the revenues at present rates?

Mr. SCHMIDT. I would think that would depend in part on the budget for 1957.

If we are in inflationary condition, and the budget happens to be higher we certainly would not want to stimulate inflation, so that that would be conditioned on what we learn next month and what you gentlemen do and what the House and Senate do on appropriations.

Senator DOUGLAS. Let's see if I understand your answer.

Do you have some fears that a tax reduction might drive up prices by releasing more purchasing power to private individuals?

Mr. SCHMIDT. I personally don't have much fear in terms of the timing because I think while there may be some upward pressures in the first half of 1956, I think they may be less pronounced in the last half of 1956.

Senator DOUGLAS. Do you expect a recession?

Mr. SCHMIDT. No; I don't expect a recession, but I think the buoyancy that is carrying over from 1955 will possibly——

Senator DOUGLAS. Lose a little of its zip?

Mr. SCHMIDT. It could.

Senator DOUGLAS. Do you think there is no damage to be done by injecting a little zip into the economic bloodstream?

Mr. SCHMIDT. That would be one way to put it. We certainly put high priority on debt reduction in a period of inflationary pressures. That ought to be given high consideration.

The first consideration ought to be Government economy and, second, debt reduction.

Senator DOUGLAS. So if the prices are rising, you would say that debt should be reduced, and this would help reduce the amount of bank credit.

Mr. SCHMIDT. Depending a little on what type of debt is retired. I think we should be very selective in that.

Senator DOUGLAS. That could be done by purchasing either the Federal securities held by the Federal Reserve Board or by the banks.

You could thus reduce the expansion. At least, in bank credit.

Mr. SCHMIDT. That is right.

I don't think we ever should overload either fiscal policy or monetary policy.

Senator DOUGLAS. You are not plumping at the moment for a $3 billion tax cut?

Mr. SCHMIDT. I have no specific figure in mind.

We probably will have a figure.

Senator DOUGLAS. But it would not be in excess of $3 billion or would not be in excess of the expected increase in revenues at present rates?

Mr. SCHMIDT. Assuming a budget for 1957 equal to 1956, I would think something on that order, although I would hesitate to commit myself at this moment.

Senator DOUGLAS. Mr. Stein, I notice your organization has no such inhibitions.

They are apparently all out for tax cut, by reducing the corporate tax, and I believe the upper brackets in the income tax. It was late at night when I read your bulletin.

Mr. STEIN. I think possibly our inhibitions did not carry over until late last night. The statement the committee issued was contingent on two factors: The first was what the planned expenditures of the Government would be, which we were only estimating and about which we said of course that everyone would know much more after the Federal budget was issued next month, and, second, the recommendations were contingent in a rather special way on the state of the economy at the time the tax decisions were actually to be made. The committee did say that if expenditures next year are very close to the

present level of expenditures and unless we are experiencing a very severe inflationary pressure next spring, the committee would be in favor of a tax reduction of approximately $3 to $4 billion.

Senator DOUGLAS. Concentrated on reduction in the corporate tax, and in the upper brackets of the income tax; am I correct?

Mr. STEIN. No; I don't think that is quite what the committee said or had in mind.

We wanted particularly to direct attention to the need for the reduction in the corporate-income tax, and in the upper-bracket individual-income tax.

Senator DOUGLAS. I notice on page 8 you say:

> With these considerations in mind the committee recommends the corporation income tax be reduced at least 2 points on the date for scheduled reduction, April 1, 1956.

Mr. STEIN. I was merely objecting to the word "concentrated."

Senator DOUGLAS. On page 7 you say it is the committee's view that all income tax rates should be reduced but a relatively greater percentage reduction in tax should be made in the middle and upper brackets where extremely high rates are seriously interfering with the incentive to take risks and with the supply and mobility of investment funds.

It would seem to me a relatively greater percentage reduction in the middle and upper brackets, plus a cut of 2 points in corporate tax, justifies the term "concentrate."

Mr. STEIN. May I read the sentence after the last one you read from the CED report, sir?

> In absolute amounts the savings will go largely to taxpayers in the lower brackets because of the large number of people affected.

Senator DOUGLAS. That is another question.

Now I wonder if the other men on the panel would have any comment to make about whether there should be a general tax reduction.

I would like to raise one query: I was somewhat struck with the fact that the CED now seems to say that the test of balancing the budget is the so-called consolidated cash budget, not the normal administrative budget, the difference between the two being of course the social security system. At present I believe receipts from payroll taxes exceed benefits by about $2 billion in the social security system.

Now I remember the very severe criticisms which the business community advanced some 20 years ago to this idea of taking the cash budget as the test. If, of course, one does take the cash budget as the test, the period 1945–52, was one of a very large budgetary surplus I believe, of some $8 billion.

The cash budget was more than in balance during this period.

I wonder if we should make as our test simply keeping the cash budget in balance because I had always thought that sound finance required, whether or not it has been practiced, that the excess of contributions over benefits in the social-security system should be invested in types of investment and types of captial which increased the productive capacity of the community and therefore created income—real income to the community—which could be disbursed later in a period when the increased benefits came due.

In this respect, I think I am much more orthodox than the CED, and some members of the business community.

I don't think we should abandon the administrative budget as readily as now seems to be done.

I would like to have some general comments on that point from the other members of the panel. Assuming that everything goes well next year and that we get an increase in revenues at present rates of 3 to 4 billion, which would probably produce a surplus in the cash budget of approximately that amount, but a surplus in the administrative budget of a billion or so, should we go ahead with the net reduction in tax rates.

Mr. Samuelson?

Mr. SAMUELSON. I should like to register a mild dissent from some of the views expressed here.

So often one reads that, because business activity has been so strong that our tax revenues have gone up tremendously within the framework of the same tax rates, bringing the budget in balance and even beyond the point of balance, that this is a reason and occasion for tax reduction.

On the contrary I would say that sound economic doctrine would hold exactly the reverse; precisely because business has expanded so fast, and so far, as to create the increase in revenue, do we need the extra tax collections as our built-in stabilizer, our first line of defense, and the more the surplus develops from spontaneous zip, in the economy the weaker becomes the case for tax reduction.

Now, Mr. Schmidt, on my right, may be a very keen prophet, of the future. His suspicion that the last 6 months of 1956 may show some relaxation of demand may well prove to be correct.

I have no firm opinion on this subject.

I do think this: that in talking in early December about a tax policy for fiscal 1957, it would be premature to say the least to form an opinion in favor of tax reduction at this time. If, when April comes around, some swallows of a recession appear, then I think we should begin to speak of reductions, but I find it paradoxical that at a time when the Federal Reserve is tightening up on business investment, making it difficult to float new issues, making investment bankers think twice before bidding on an issue, because in a time of tightening money, the price slips between the Monday when they make their bid and the following Thursday when they have to sell to the public—this I am told and I believe half of what I am told has an inhibiting effect on private investment, and private flotations.

If we were called into the Federal Reserve or asked what to do for the following year with respect to monetary policy, I think you would find 95 out of 100 economists would say "Prepare to hold the line, prepare to lean against the breeze; if the breeze stops blowing in that direction, reverses itself, then reverse policy." Why then should economists come before a subcommittee on taxation and at this stage of the game, with investment so strong, be speaking of business-tax reduction?

I read the Wall Street Journal this morning. The newest figures are out, showing a 12-percent increase in planned capital formation.

As one interested in 1 of those 5 factors, growth, I am very much interested in this but I fear that by next May, it might be throwing kerosene on the fire to reduce corporation tax rates by 5 percent, if it has the nice effects that Mr. Stein thinks it has, which are a little more powerful than Mr. Fellner thinks.

Nevertheless, humbleness with respect to forecasting, which I think realistically we all share, would suggest that every day so far the case for tax reduction is getting a little weaker rather than stronger.

Senator DOUGLAS. Every day the demand for tax reduction seems to be getting a little stronger.

Mr. SAMUELSON. Yes.

Mr. SCHMIDT. What Mr. Samuelson has just said, I don't think differs in any sense from what I tried to say.

Mr. DAVIDSON. I would like to make a point if I might, Senator, and Professor Samuelson, that it seems to me we are overlooking a very real reason for the inflationary pressures that are developing, and it seems to me that they indicate more than anything else that we are straining at the seams of our productive capacity and that should we have stronger inflationary pressures in the succeeding months it would be added evidence that our tax system is prohibiting the adequate formation of savings to go into expansion, and to me it would be added reason for cutting those taxes which impede capital formation. I might say that that would not be inconsistent with the monetary restraints which were cited because those restraints have been used to reduce debt, which results in new money, as a means for financing expansion.

If you did reduce the high tax rates which impede capital formation through the normal process of saving you would get capital formation without inflation, so I think the reasons that he cited actually should be interpreted as reasons why we should reduce the rates, and I think I depart from perhaps most of the panelists here in my not believing that the case for tax reduction is dependent upon a little shift in prices and other trends, here and there, over a few months.

I think we have very adequate evidence in this country that the rates do impede capital formation, especially the kind of capital formation which is not inflationary. You will not have a strong, noninflationary expansion until you provide for more saving out of the normal processes of the economy.

Mr. MILLS. Mr. Stein?

Mr. STEIN. Mr. Chairman, I would like to comment on Mr. Samuelson's remarks. So far as the CED is concerned, the increase in revenue which the committee would like to devote to tax reduction is not the increase that will come from added zip in the economy, as has been described. That is to say, we are talking about the increase in revenue that will come from the normal growth of the labor force and productivity not from the increase in revenue that would come from an inflationary development, or even from——

Senator DOUGLAS. I think I made that clear.

Mr. STEIN. I believe it was clear in the committee's statement but it seems to have been misunderstood here. If there were additional revenue, as a result of a rise in the general level of prices, or a reduction of unemployment below its present level of approximately nearly 4 percent of the labor force, the committee would believe that that additional revenue should be retained as surplus, and not be expended in tax reduction.

With respect to the question of the consistency of monetary and fiscal policy I think what consistency requires is that the combined

effects of monetary and fiscal policy should be in the proper direction, and in the proper degree.

It does not require, I believe, that both instruments should always be operating in the same direction.

I don't think there is anything that requires us in an inflationary situation to be using every instrument as far as it will go. If we are confident that the combined package of monetary and fiscal policy will serve to restrain inflation, we have a question of the balance, the mix, within this package, that we should use. It is the committee's belief that the mix should be governed by the rule that taxes and expenditures should balance at high levels of employment, and that within a reasonable range about that the task of restraining inflation or deflation should be left to monetary policy.

Mr. RUTTENBERG. Mr. Chairman, I wonder if I might get into the fray at this point?

It appears to me as if I might be a minority one on this panel. I think that tax reductions next year from the standpoint of equity, even if there were no other considerations, should be made. Tax reductions in the form of higher exemptions, or the change of the first bracket tax, which Mr. Davidson suggests—I think equity in this direction is necessary next year.

I think there are other arguments beside equity, however, which should be taken into consideration.

I am not so sure that the inflationary pressures which seem to be talked about are as evident as some people like to make us believe they are. Yes; it is true, the growth in the economy over the past year has been, in terms of GNP probably in the neighborhood of 7, 8, or 9 percent. This has been a rather large growth, but it is a growth which compensates in part—not totally, but in part for the decline in GNP which took place in 1953–54.

Now, as we move into 1956, the question is, and of course, nobody can answer this with any degree of certainty, but the question is, will the economy in 1956 grow to the extent necessary to provide full employment levels, absorb the increase in the labor force which all of us around this table will agree will come into being in 1956?

Will the economy grow enough to take care of the workers displaced in 1956 as a result of rising productivity?.

I don't think, as I said, any of us can answer the question of the level of economic activity in 1956 with any degree of certainty. There are many factors in the picture which lead me to conclude that while we will certainly not have, a downturn in the first part of 1956, or maybe throughout the year 1956, that the growth will not be as rapid and as continuing as it should be. It is for this reason that I recommend strongly that there be tax cuts in 1956.

Now, the question is——

Senator DOUGLAS. Are you referring to reductions in total tax revenue, or readjustments within the tax structure, because the two are very different?

Mr. RUTTENBERG. I would first talk about reductions within the present structure of revenue. I think this is quite possible and conceivable to accomplish. However, short of accomplishing that, I see nothing really seriously wrong with reducing taxes by three of four billion dollars in 1956. The question is what kind of tax cuts, and I

would like to call attention, if I might, in order to solicit a comment or two from the panel members, to the agreement as it appears between Professor Fellner and Dr. Stein on the effect of corporate-tax reductions on economic growth.

Mr. Stein in his paper says:

We should not be deterred from reducing taxes that repress investment by the fear that the result will be inadequate markets for the product of investment.

Dr. Fellner comments, I think, in that same manner by saying something similar:

The magnitude of this investment-raising effect per dollar of tax reduction—

that is in corporation-tax reductions—

is less predictable than is the magnitude of the consumption-raising effect of lower bracket individual tax reductions.

It seems to me what these two gentlemen are saying, is close to the thesis which I have tried to develop in my paper, that tax reductions to stimulate investment, may not be sufficiently stimulating enough to cause growth. Dr. Fellner concludes, if it isn't, then reduce the corporate tax even more than the individual tax cut that would be necessary to accomplish the same objective.

Mr. Stein says, don't worry about it because it wouldn't have the effect that you say it will have.

I think the facts, as I see them in the situation, indicate to me that we have an economy which is moving into a very rapid period of productivity advances with automation and capital expenditures for new investment. As important as the investments are—they must continue to keep the economy growing—they are not the key essential factor in stimulating growth. That is the point I tried to make in my paper. It takes less dollar of capital investment today to get more output in the future than it has in years gone by.

This comes about because of automation, because of mass-production industries which create a tremendous level of product that must be bought up and consumed, and it is not going to be bought up and consumed by stimulating investment incentives through corporate tax reductions that tend to trickle down to the lower levels.

Senator DOUGLAS. May I address another question—this time to Dr. Schmidt?

Dr. Schmidt, in the statement which you made this morning on page 5, you speak of panelists who have lamented the erosion of the tax base, the growth of real or alleged loopholes, escapes, special exemptions, exceptions, preferential treatment, and leakages.

You argue that the loopholes exist because of the previous high rates. I would like to raise the question as to whether or not in fact the opposite is true. Is it not true that every erosion of the base which decreases the tax income available, requires an increase in tax rates to compensate for the erosion of the base?

That is, with expenditures taken as fixed, so that as a matter of fact what happens, does it not, is that the existence of these loopholes creates inequity between people receiving the same amounts of income and requires the imposition of a still higher rate of progression in order to make up for the loss of revenue causing the loopholes. The amount of revenue that goes through, however, is much larger than a loophole.

Mr. SCHMIDT. I don't think anyone could deny that there is action and reaction here, as you imply, but I think it does suggest that perhaps our Republic, as contrasted to the British and Canadian, has relied too heavily on income taxation, and it might be better to go even a little further than the NAM suggests and rely more heavily on excise taxation.

I think the theorists would generally agree that income taxation does encourage the search for loopholes, it does discourage effort, whereas excise taxation probably stimulates effort, so that I don't know as you could——

Senator DOUGLAS. That brings up a very interesting point. In your detailed paper on pages 236 and 237 of the green book, you say at the bottom of page 236 that—

> * * * the progressive income tax, with high marginal rates, does discourage work, effort, and particularly, risk taking.

In other words, taxes on the well-to-do discourages them from putting out added effort, but in the middle of page 237 you say:

> A sales or excise tax probably stimulates effort because if things we want cost a bit more we may have to work a little harder or a little more ingeniously in order to earn enough income to buy the things we want.

Now you are saying that excise taxes on the poor cause them to work harder but income taxes on the well-to-do cause them to work less.

I am curious as to the difference in incentive you bring forward. It seems to me offhand that there is a contradiction.

Mr. SCHMIDT. Well, I don't think so. It is obviously an area in which we are dealing in the realm of the subjective, but granted that you have a certain standard of living in mind that you are accustomed to, if an excise tax is put on something that you regard as essential, you are probably more willing to work overtime or an extra day or take an extra job in order to maintain the status of your family.

Senator DOUGLAS. Wouldn't that also be true of the well-to-do then?

Mr. SCHMIDT. No. I think not, because part of the well-to-do's income goes into saving. I know of a case, a famous writer, for example, who was urged very strenuously to write an article for a magazine—this was about 12 years ago, and the price was $300.

He said, "It would net me $60 and it simply would not be worth the effort to write that article for $60 because of the net I would get."

I recall several Hollywood problems in this connection, where a famous radio star refused to make a second or a third picture in a particular year, simply for this reason.

I am not worrying about that star's decline in income, but by failing to make that picture, there were all sorts of actors, that did bits and pieces, and script writers who did not get jobs because that actor decided not to work.

Senator DOUGLAS. If you increase the tax burden according to your contention on the low-income groups this would make them work harder.

Mr. SCHMIDT. I think given a certain scale of living, standard of living rather, rather than a scale, to which they are accustomed, I think none of us likes to take a cut in our scale of living. We don't like to tell our families that you have to eat a little less.

Senator DOUGLAS. Wouldn't this be an argument for increasing the income tax in the upper brackets, to cut down on their free income after taxes so they would have to work harder in order to get the same net income?

It seems to me you have brought out an admirable argument for increasing taxes on upper income tax brackets.

Mr. SCHMIDT. It isn't two sets of people.

It is a different set of economic conditions. Once you get to the point where you have not only the necessities but the comforts of life and the balance goes into luxuries, maybe even frivolous luxuries you have to weigh as you have in many of your points, the disutility of work as against marginal income.

Senator DOUGLAS. My questions have already consumed perhaps more time than they should. I don't want to shut off Congressman Curtis and Congressman Mills. I would only like to close with this, and that is that we always seem to believe that taxes have a good effect on somebody else. They are excellent for other people because they make them work.

Mr. SCHMIDT. You will notice I put the word in, "perhaps" or "possibly," on the second quotation which you read.

Mr. MILLS. Mr. Curtis will inquire.

Mr. CURTIS. Mr. Chairman, I want to start out on a new line perhaps to find out what area of agreement there is on the panel and then go from there.

As I gather from the paper and statements made here there is no question but a balance between the investment dollar and consumption dollar must be struck. Mr. Ruttenberg fully realizes the need for investment, and on the other side there is recognition of the need for consumption, so, am I right in assuming that what we are talking about is what balance we strike and as to how the tax policy affects that particular balance?

I am right in that premise?

Mr. STEIN. Well, I hate to take exception to the word "balance" which is an awfully good word, but so far as the particular subject of this panel is concerned, I don't think my position is one that there is some proper determinable balance between consumption and investment. That is, I think what that implies in the present context is that you needed a certain amount of consumption in order to get a certain amount of investment.

Mr. CURTIS. Or vice versa.

Mr. STEIN. That is not the view that I take.

Mr. CURTIS. Or vice versa, because in order to get certain consumption you have to have investment, which is the position that others take.

Maybe I can approach it by going on to the detailed questions and see if there is objection.

Mr. DAVIDSON. I also, Mr. Curtis, would like to be recorded as not agreeing with the general implication of that conclusion.

Mr. CURTIS. So? That is very helpful to know that.

But going on to this question, if there is a need in our growing economy or any economy for investment capital, we come to the question of how much we project as needed for the ensuing years. Let's take next year.

As I have analyzed some of these papers, and those that occurred in the panels before, they relate the need for new investment capital to the amount of investment per worker, and I have seen those figures of around 11,000 on up to 12,000 and 13,500. That is what is needed per worker, and of course, if we are going to have a million new workers for example in the next year, at that ratio any rate that would indicate a need for 11 to 12 billions of dollars additional investment capital.

Now, Mr. Ruttenberg in his paper seems to relate it more to consumption. You feel that the need for whatever investment need there is will come as a result of the emphasis upon consumption.

Do you have any estimates to give on that basis, Mr. Ruttenberg, of how much we would need for new investment capital for next year for example or the ensuing years, and I wonder if in answering that you might comment on this concept of relating it to the need of investment per worker.

Mr. RUTTENBERG. Yes. I think all the McGraw Hill studies and the SEC estimate of anticipated business investment in new plant and equipment for next year all indicate that the rate anticipated is something in the neighborhood of $33 billion, $34 billion, as contransted to a level that we maintained in 1955 of something like 28 or 29 billion.

There doesn't seem to be the fear of scarcity of available capital that Mr. Davidson indicates, in his rebuttal statement which has been inserted in the record, but not read here, in which he deals with my general thesis that we have not only a labor-saving economy but a capital-saving economy.

He indicates that one of the reasons is the scarcity of capital. If there has been a scarcity of capital over this period of time how then can we explain that in 1955, levels of capital investment were at a new all-time peak, at least, they will be during the third and fourth quarters; that 1956 will bring about, if all the businessmen, business corporations, continue to do as anticipated, a much higher level of business investment. I can't see that there is basically a scarcity of capital involved here.

Mr. Emerson Schmidt, in his paper, says that it takes about $13,000 per worker of investment in plant and equipment, and therefore, we ought to concentrate basically, not on consumption, but on investment, because we need all of this investment.

I would like to quote from this same study, which I have talked about in my paper, study by Daniel Creamer, of the National Bureau of Economic Research on "Capital and Output Trend in Manufacturing Industries, 1880 to 1948.

In this study Simon Kuznets has an introduction and in this introduction Kuznets commenting on Dr. Creamer's paper says:

> He indicates the volume of capital per worker did rise sharply over this period, but the ratio of capital to output also declined over the decade. Presumably, in recasting their operations, lowering costs and rising productivity, manufacturers succeeded in raising the output at an even greater rate than they were obliged to add to their own capital stock.

Now, I think this is an important thesis, which I should certainly like to hear discussed around this table.

Davidson concludes that the whole concept is wrong, that Creamer's study, based upon John Kendrick's and others' studies in the national bureau is wrong.

I haven't had a chance to read why he says it is wrong, but Emerson Schmidt concludes that just the opposite conclusion ought to be drawn from what I am saying, because he says in his paper that—

> To be sure it takes less capital and less labor to produce a given level of output.

Dr. Schmidt says:

> But if we wish to expand per capita output, however, we need to create jobs for all and increase investment per job because investment per job now runs to $13,000.

What I am saying is this same study admits to this fact and does agree with the conclusion that investment per worker has increased, but basically over this same period of time, the amount of capital needed to increase output has also declined.

It has declined because output is expanding and enlarging with increased efficiency of machinery. As a result if we are going to absorb all of this mass consumption of products on the market with the investment we are having we have got to stimulate consumption levels.

Mr. CURTIS. I would like to get the reaction of the panel but before I do I would like to interject two other points that could perhaps be discussed.

Of course, when talking about capital outlay we have got 2—I want to wait until I throw 2 more things in——

Mr. DAVIDSON. I don't want to miss this. Might I make a point for the record, which is that Mr. Ruttenberg has mentioned things which I say which I haven't a chance to say yet. I do want to be sure that I do get that chance.

Mr. RUTTENBERG. They are in the record.

Mr. CURTIS. The only reason I am interjecting now is to throw a couple of ingredients into the discussion so that they will be borne in mind when you do answer.

I would like to have your answer to Mr. Ruttenberg's presentation.

No. 1, I think it is agreed that investment capital would be used for two things: One would be replacement, and the other, of course, would apply to the need for the new workers that are coming in.

The other point I would like to raise is whether or not we haven't been forgetting that there is one tremendous source of capital formation; the Federal Government, and maybe if we just relate our GNP or output to private capital investment, we are missing the fact that in this modern society we will need a great deal of additional capital. Take the housing industry. Without VA or FHA guaranties, which is capital formation, but Government doing it, I doubt very much if we would have the housing.

In fact, I doubt, I know we wouldn't have the housing industry going the way it does. So I would like to have borne in mind, in answering, whether you disagree or agree, but borne in mind this possibility of whether or not a great deal of the capital formation that has produced what we see right now, has been from the Federal Government, and tied together with the private capital formation is what is producing the GNP and how that relates to this discussion.

Now, I would be glad to have the panel comment.

Mr. DAVIDSON. If I may pick up where Mr. Ruttenberg left off, Mr. Ruttenberg, in taking a stand against relief from the discriminatory tax rate, perhaps ignoring the fact they exist and in favor of narrowing the base of the individual tax, has anchored his case to two propositions: (1) The fact of growing consumer markets means we don't need as much investment. I would like to echo the point that Dr. Schmidt made so well, that the very fact of our growing consumer markets provide positive evidence of the richer rewards which may be realized by all citizens if tax policy does not impede capital formation because if we have more capital then we get even more things from it. But more importantly is his second point that he tied his case to, namely, the rising productivity of capital.

If he is wrong in his interpretation of tax benefits of certain statistical studies which show that productivity of capital has been rising for some years his case not only falls apart but actually lends tremendous weight to the opposite conclusion, namely, that the first priority in tax reductions should be given to reducing the rates which harass economic activity, and which impede capital formation.

It is, I believe, readily demonstrable that he is wrong. Greater capital productivity is an indication of capital scarcity, not of capital abundance. Instead of evidencing a declining need for capital the data he uses provides the concrete evidence of a growing scarcity of capital.

The only logical conclusion that can be drawn from the data is that the removal of tax obstructions to capital formation becomes a more important objective of policy.

What I have said, Mr. Chairman, is based on an analytical paper which you have kindly accepted for the record, prepared by George Hagerdorn, who is the associate director of our research department. It is, I think, of such dramatic significance to the proper resolution of the issue before this committee that I believe it would be worth while to read it in its entirety. However, I realize that would take some time and if you would permit me I would like to read a few paragraphs from it.

The Ruttenberg paper—quoting from the document which has been filed in the record:

The Ruttenberg paper interprets the decline in the ratio of capital to output as being due primarily to advances in engineering know-how. As a result of such advances (according to his analysis) we are able to get more in the way of output for each dollar invested. This may be called a purely technological interpretation of the observed increase in capital productivity. While this is an important part of the picture, it is very far from being the whole picture. The productivity of capital at any time must be a joint effect of the state of technological know-how on the one hand, and the availability of capital on the other. An improvement in know-how may raise the average productivity of a given supply of capital. On the other hand, in a given state of technological know-how an increase in the supply of capital will reduce its average productivity. There are—

And this is most important:

at any given time a practically unlimited number of possibilities for using capital. These would vary greatly in their productivity. For example, some of the possibilities for using capital would produce an enormous output per dollar of investment and some would produce only a very small output per dollar of investment. Since capital is always in limited supply; all the conceivable possibilities cannot be taken up, but at any given time capital is allocated to the

various possibilities in the order of their productivity, and the best opportunities inevitably are taken up first.

The more capital we have available, the further down the scale of capital productivity we will go. When capital is scarce it will be used for purposes which yield more return on the average than when capital is plentiful, other things being equal. Thus, the national bureau's results, far from refuting the contention that we have a shortage of capital, corroborate that belief.

I am just going to read the concluding paragraph:

Realistically considered, the rising productivity of capital indicates that it is now more than ever important to remove tax obstructions to the formation of capital. Each additional dollar made available can contribute more in the way of added output than in previous periods of our history. There is more to be gained in the way of an increase flood of goods and services for each dollar capital set free by tax reform.

Mr. CURTIS. In your reference to capital you are talking about private capital formation?

Mr. DAVIDSON. That is right.

Mr. CURTIS. What would be your comment as to the fact that in, would you agree that there has been a considerable amount of Government capital formation that lies behind a great deal of this present economy of ours?

Mr. DAVIDSON. Well——

Mr. CURTIS. How would that gear him?

Mr. DAVIDSON. I think you used the particular frame of reference of the housing program?

Mr. CURTIS. It was simply an illustration. I can give you the CCC, FIDC, and any other thing from the standpoint of guaranties, and yet those things are essential capital—needed capital formation in order for this economy to go, so if it doesn't come from Government, if we were going to do it, it would have to come from private capital formation.

Mr. DAVIDSON. To take the two cases you have mentioned, as far as the FHA is concerned, that is mainly an insurance of a loan of money made available through the private banking system.

Mr. CURTIS. But it is necessary in the economy.

Mr. DAVIDSON. The capital is provided by and large from the private banking system. In regard to the Commodity Credit Corporation, I think its significance for capital formation perhaps would only be in that it may encourage more investment of capital in production on farms than might be warranted if we operated under more of a free market.

Mr. CURTIS. The point is this, I don't care whether you say the actual money put up comes from private investors, if FHA as an insurance endeavor where in private enterprise it would take private capital; you would have to have considerable private capital formation to take its place.

Mr. DAVIDSON. Yes; I see your point. I agree to the extent that the Government has been doing things it shouldn't do with taxpayers' money and stops doing those things then it is even more important to me that taxes do not impede the doing of those things in the private economy.

Mr. CURTIS. I wasn't saying whether they should or should not. I was trying to analyze this thing in relation to the question of how much capital formation do we need, how do we estimate the amount

and in considering that I think for an economist at any rate you have to consider Government capital formation, because it enters into these things. I am really directing myself to the basic question, how much capital formation do we need and how do we estimate the amount.

Mr. FELLNER. Mr. Chairman, may I comment just very briefly on a question Mr. Ruttenberg raised here in connection with the productivity of capital, just to point out where there is agreement, I suppose, about the empirical findings and where subjective judgments do enter.

I think it is a fact that the same capital outlay in dollars today gives us a higher increase in output than was the cast in the past.

To get a given growth rate we seem to need less capital today, less additional capital today than we did in the past.

These are the findings I think Mr. Ruttenberg was referring to.

Mr. SAMUELSON. Is this agreed on by all the members of the panel?

Mr. CURTIS. I want to be sure of that.

Mr. SAMUELSON. I would be inclined to think that that is well established.

Mr. FELLNER. Let us really find out.

It depends where you start. I think this capital requirement per unit of output growth, this capital requirement per unit of growth, output growth, has shown sort of a long cycle. It depends on where you begin, if you want to compare it with the past. I think we now need less than in most past periods, although there was a period somewhere in the 19th century apparently where the capital requirement per unit of output growth was rising, but from there on it seems to have been falling, so I think it probably is generally agreed that the capital requirement for 1 percentage of growth is now smaller than 50 years ago.

Mr. CURTIS. Could I sak you on that particular question, in those studies do they take consideration of Federal capital formation? Is that included in estimating how much capital is needed?

Mr. FELLNER. An attempt is made to include it.

I don't know how precisely or completely it is included, but these are based partly on figures Professor Kuznets has computed, and estimated, and those do include Government capital formation. When they are based on other figures, an attempt is made somehow to include capital formation that takes place in the public sector.

Unless I would be contradicted on this, we may assume that there is an agreement on this being a reasonable presumption. The facts seem to point in this direction.

From here on the inference will be subjective. It is possible to derive from this two different kinds of inference. One inference is where we have reasonably high growth rates even with comparatively little capital formation, so why worry about growth, and I think that Mr. Ruttenberg's reasoning somehow moves along these lines, or at least this is not inconsistent with what he is arguing.

On the other hand, of course, you could argue in this fashion: that it takes comparatively little additional capital now to get more growth and therefore it is well worth it. To put it in more concrete terms, these figures show that perhaps it takes no more than 2 to 3 years for the economy as a whole to recover the sacrifice in consumption which is involved in using output for capital formation.

This, of course, is in contrast, or is very different from the rate at which the investor himself recovers the capital that he invests.

The reason for this difference is that not only the investor's income rises when there is more capital formation, but that the higher capital to labor ratio, the rise of that figure which now is somewhere between eleven and thirteen thousand dollars of capital per worker, leads to rising wages, and therefore, the total increase in income for the economy as a whole is a much higher proportion per year of the capital investment than is the investor's income.

Consequently, if we take the total capital formation, we can say that it is recovered, or has been recovered recently within 2 to 3 years for the economy as a whole.

Now, I would not necessarily extend this numerical estimate to any additional investment, because if we push investment further. we can not take it for granted that that increment will also be recovered within 2 to 3 years, as the total investment has been recovered within 2 to 3 years.

Still perhaps, it is not too optimistic to assume that there will not be a very sharp difference between the rate at which the additional further investment would be recovered and the rate at which investment on the average has been recovered recently, and this would mean that within—I don't know, less than 5 years, the community would get back what it put into capital formation in terms of income and from there on it would be a net gain, so to speak. So here at this point I think subjective judgment is needed: where I myself in my testimony took the position that in such circumstances it is well worthwhile to push investment a little further, while the other subjective judgment that can be derived from the same set of figures would be to say—"Well, we have enough growth, even with little capital formation, why push it further."

I think if we can recover it within 2 to 5 years then it is well worthwhile to proceed a little further.

Mr. CURTIS. I wonder, could I make this suggestion? I would like to hear from any of the panelists and then return it to you because it started with you. If we could get some comments, if there are any from the other panelists.

Mr. STEIN. I find myself with complete agreement with Mr. Fellner's analysis and with his subjective judgment on the conclusion.

Mr. SCHMIDT. I agree with Mr. Fellner. I think it is a little unfortunate that Mr. Ruttenberg did such an excellent job of bringing all these quotations together, and then drew what I think are completely wrong conclusions.

Mr. RUTTENBERG. In your judgment.

Mr. SCHMIDT. No.

I think the evidence is so clear. Otherwise, how do you explain our rising standard of living, if it wasn't in inflow of capital and new investment, and Mr. Curtis, on your point of public capital, while I think we all have our doubts about the Government getting into these fields that you happen to have mentioned—there is something to be said for and against them—you haven't mentioned other areas of public capital that are very important without which private capital could not go forward, such as municipal water systems, schools, sewers, and so forth. The coming Congress is going to have to wrestle very

diligently with the problem of what to do about our deficiency of public capital. I think you are quite right but I would put the emphasis on the things that the communities need in the way of facilitating expansion in housing, and all the other things, through the private sector.

Mr. CURTIS. My point was simply I thought we were dealing with the whole economy, in trying to determine how much capital is needed to be invested; you have to have the whole picture. You couldn't stop with one, although it does become important for other reasons of whether it should be public or private. I didn't want to get into that.

Mr. SAMUELSON. I should like to make three comments on the thought you have suggested.

First, I very much agree with you that the role of the Government and effect of Government policies has not at all been neutral in capital formation.

On the contrary, not only through the agencies that you mentioned, but through all legislation, there are very important effects upon capital formation. I would like only in this discussion to stress one.

We must distinguish as economists I think between the mere duplicating of capital, the getting more of the same things which it is true is productive, but leads you down the road of diminishing returns.

As against that, there is the creative act of technological innovation, both in purely science and applied technology. Now, I look with the greatest of pleasure upon the very heavy support of basic research which the Federal Government has been giving in the postwar. It is true that this has been the result of our feeling of national insecurity, but the effects have been very favorable; not only in universities like my own is there a tremendous amount of basic research going on financed by the Government but if you go into private industry and if you look at what seems like a perfectly private, purely free-enterprise activity, you find that it is underwritten by defense contracts.

Today you have only to look at the want ads. The engineer, the aeronautical engineer, the man in the field of guided missiles, the expert on mechanisms, that man is in the saddle. He is in strong demand, and I have been interested in tracing out how indirectly, through Federal expenditure, this has come about.

My second comment, is on the whole problem of equity capital. I wonder if it is realized what a tremendous increase in the effective amount of equity capital we have gained in the postwar American policy as a result of sound policy with respect to economic stability. Why do you want equity capital? Why is it dangerous to pyramid debt on top of the very limited amount of personal capital?

It is the riskiness that is involved. How well we remember in the 1930's the risk of business cycle collapse, which was present in every commercial banker's mind in making loans, every investment banker in floating loans—we had an excellent study by a former colleague of Professor Douglas, Professor Viner, and Dr. C. O. Hardy, on the availability of credit in the Chicago Federal Reserve District during depression.

We have numerous such studies, and if I had been a banker at that time, if I had weighed the probabilities prudently I would have done exactly what they did.

Now, see how different the situation is. The effective risk of a tremendous slump which used to penalize the strong and the weak, has tremendously decreased.

I wouldn't want to come before you and say we are in a new era where we never can have a depression again. Nevertheless, I think any prudent man recognizes how great the reduction has been in that risk. I attribute this in very great measure to our changed governmental policies and institutions.

We have a framework of built-in stability, we have repeatedly shown that we will have the discretionary action aimed against minimizing this risk. The result is that if you just go to balance sheets and look at the amount in the proprietorship account, you might conclude that the effective amount of equity capital has not increased. As a matter of fact, despite piling on more and more debt, because of the very heavy plowed-back earnings, it is surprising how little dissolution there has been. I shouldn't have predicted there would have been so little increase in leverage. Nevertheless, go below the surface and look at the effective amount of equity capital there. I think it has tremendously increased.

One example of that: Accelerated depreciation was written into the law last year. To the extent that this gives amortization faster than equipment actually wears out in value—some would say it only is in many cases corrective of inequity of computation of length of life, but to the extent that it gives more rapid amortization—that is just like having the best kind of partner in the world.

He is the man who gives you an interest-free loan, but better than that, he shares in the risk. It is a loan which you won't have to pay back unless everything turns out well and you will never have to pay back out of capital, but only out of current income.

We can overdo that. Maybe the investment figures are getting awfully strong and we may have to do some second thinking on these things, but this is just one of a number of examples I could give showin the creative role of "we the people" in the field of capital formation.

Now, I want to go to the third question. I think Professor Fellner gave a masterly analysis of what the effect is of an increase in the marginal productivity of capital, due, perhaps, to technological change; how he was able to express that in such a man-of-the-street language, I don't know. I am all admiration. On the other hand, the whole result of that, as I understood it, was that nobody can come to this table and speak with conviction about what is clear in the facts. He said, on the one hand, we have this, on the other hand, that. Then not Professor Fellner but Mr. William Fellner, of New Haven, Conn., expressed his thoughts about thriftiness. Micawber gave sage advice to David Copperfield. We know his views on the subject. We know what Mr. Fellner's rate of time preference is. He has extended this to the community, and to the extent that the community shares his views, they will so act.

I think that we will find out what the time preference of the American community is when you gentlemen, instructed by your constituents, pass the tax bill in the spring. There is no hard and fast need that particularly dictates this in advance.

We write our own scenario. We are free wills in a Republic. Republic, I think, is the proper expression to use here.

Mr. Curtis. Thank you very much.

Mr. Ruttenberg, now it comes back to you.

Mr. RUTTENBERG. I would like now to say I agree fully that Professor Fellner has stated the issue in an accurate way when he said, to get a definite growth rate, we need a lesser amount of capital.

I think that is the conclusion to which the national-bureau studies come; not only in the field of Daniel Creamer, which is strictly manufacturing, but other monographs which the national bureau has put out, or is about to put out come to the same conclusion in agriculture and mining so the general concept that a lesser amount of capital is now needed to get a definite rate of growth is, I think, an accepted general thesis although it seems to me Mr. Davidson doesn't accept that thesis.

It seems to me that the question here is one that I would like to pose in a slighly different way. I would agree that Professor Fellner states the subjective judgment I come to quite accurately. He disagrees. We come therefore to different subjective. I would like to pose the problem on which the subjective judgment is drawn in this way. Let us start with the GNP analysis of the economy. The three major sections which go to make up GNP are capital investment, consumption, and Government, the fourth for investment is a negligible factor and therefore can be disregarded. I think the facts of an analysis of the GNP indicates that business, plant, and expenditures are now taking a lesser percentage of total gross national product than in previous years, in spite of the fact—in spite of the fact that we have large substantial increases in business investment.

This is substantiated by an authoritative source, a source which comes from another point of view than the one which I represent.

It comes from a publication—February 1954, the Capital Goods Review—published by Machinery and Allied Products Institute. This is the organization of which Dr. George Terborgh, I think, is director of research.

Here is the conclusion to which they come. May I read a paragraph out of my longer original statement, which has been inserted into the record, and this is a quote from the Machinery and Allied Products Institute.

> When we put plant and machinery expenditures together we find the postwar expenditures of gross private product about the same at constant prices * * * as the predepression level. * * * So far, as these figures can be relied on, we may conclude that the postwar percentages for plant and equipment combined have been close to, if not indeed a little below, those suggested by predepression experience.

Now, if business investment as a percentage of gross national product, is slightly less than predepression years, then in order to get a stimulation for growth in the economy we must rely upon the other three factors, and we disregard for the moment foreign investment, and come to Government or consumers. The conclusion therefore in my subjective movement is that we either move toward increasing Government expenditures for the kind of growth, the kind of programs which Congressman Curtis is talking about, to stimulate more investment in these areas, or we do something to pick up the other facts. So in total gross national product and that is consumption levels. I think the issue comes down to this: whether you say there is a shortage of capital or whether you say there wasn't a shortage of capital during this period I think from the analysis of the GNP figures one can conclude that business investments are taking lesser

percentage of the GNP. Therefore, we must increase either consumer or Government expenditures. I am in favor of raising consumer levels of expenditure. Therefore in the tax field and leaving aside all other areas, I believe tax policy should be directed at income-tax reductions in the main for the low- and middle-income brackets because they are the people who do the consuming.

Mr. CURTIS. Thank you, Mr. Ruttenberg. I want to make one observation so that it can be corrected if there is disagreement.

You keep referring to investment in plant and equipment. Of course, I believe, and I think you agree, that our mass-production system is based upon a mass-distributive system, too, and the overhead investment required in order to have mass distribution is just as much a part of the actual investment as that in the plant and equipment.

That is why I try to get this concept of overall capital investment needed, and that is why I wonder whether the amount actually has decreased.

I can't back this up, but it seems to me the amount that is increased in need in order to go ahead in this complex society. What we possibly are doing is segregating certain things and calling that the need for capital investment, when actually this whole picture is what is needed.

I wanted to go on, to bring at least my questioning and observations to a conclusion, because, taking your philosophy, Mr. Ruttenberg, it seems to me that what you do there is to have a tendency to create a demand before the supply of private capital is possible.

I am not saying it is so, but it might be that tendency, and yet Government, through taxing, and other ways, is possibly inhibiting private investment, accumulation of private capital, and it creates a tremendous pressure on people like myself in Government, where you have got the demand and the need for capital formation, and not available in private enterprise, where you come to Government for it. It almost subverses what you stated in page 218 in your basic statement, where you say:

Since we are all interested in holding the role of Government expenditures to the minimum, economic policy must be directed toward encouraging, stimulating, and correcting incentives to increase consumer spending.

I, of course, as a person listening to some of the debates on appropriation bills, wonder if everyone is interested in holding Government role of expenditures down. But whether we might have that objective or not, it would seem to me the emphasis you place would defeat the very thing that you are stating: The emphasis, the pressures, would be on greater Government expenditure, and that in turn puts us in the position—this is my observation—that our problem in taxing at any rate is the very high tax take needed. Therefore, the higher take will continue to spiral, because we won't have the private capital formation needed to assume these burdens, and therefore we will have to go on from there.

Whether or not that is good or bad, I am not commenting. I am just trying to see if that is not actually what occurs.

Mr. RUTTENBERG. I think what I said, Congressman Curtis, you recall, was that if you conclude that business investment as a percent-

age of gross national production has declined you have got to move either to the Government or consumer sector.

I would prefer to move to the consumer rather than Government sector, although it is necessary for Government to expend an increasing proportion of its revenues for public roads and hospitals and schools and other areas, but that can be done on a relative base without increasing the Government's contribution to the total GNP if the consumer base has expanded along with it.

That is my thesis.

Mr. DAVIDSON. As I read Mr. Ruttenberg's papers and listen to him, I get the feeling that if we did not have big government we would have to create it in order to accomplish the objectives in which he is interested.

Mr. RUTTENBERG. This is not what I have said any place, Mr. Davidson, although I have no objection to big government.

Mr. DAVIDSON. It seems a rather logical conclusion to the idea that you must use the whole Federal fiscal system to accomplish results other than fiscal purposes. I did want to say, Mr. Curtis, that Mr. Ruttenberg had indicated that I was in exception from acceptance of the thesis that we need less capital today to get a given growth rate.

Obviously I agreed with the data which he had presented in that connection, and only interpreted it differently.

I again come back to the conclusion that I don't know how you can use such good data and reach such illogical results as has Mr. Ruttenberg. We are quite convinced ourselves that these data indicate the greater opportunities for use of capital than do exist, if we will remove some of the tax impediments to capital formation.

Mr. MILLS. Senator Goldwater?

Senator GOLDWATER. I do not know whether this is a question, or comment to ask a comment on.

I am very interested in this theory of increasing consumer power. I happened to be a salesman and in the business of selling. I listened to the debates last year and the year before, when tax cuts were suggested, and the argument for the tax cut was based on the fact that it would increase consumer power.

These increases as I recall would have been in the neighborhood of two to three billion dollars, about what we have been talking about generally through these discussions. That is not a lot of money when we compare it to the GNP or the total income of the country.

I have been very dubious about its long-range effect or even its immediate effect on the economy.

For instance, let's say that we started in what appeared to be a mild dollar recession. Would two or three billion dollars in tax cut in the $10,000 and lower-income brackets be effective, really effective, in the stopping of such a decline?

Would any of you want to comment on that?

Mr. STEIN. I would only make a fairly obvious comment, that while two to three billion dollars is a small amount relative to the total size of our economy, it is a fairly significant amount relative to the size of fluctuations in our economy, especially if you talk about a mild recession.

I suppose we would think that $10 billion drop in our national income would be a noticeable recession, and two or three billion dollars is significant in relation to numbers of that magnitude.

Senator GOLDWATER. Mr. Samuelson?

Mr. SAMUELSON. I would say that the question that we have to ask ourselves is what is the effect of each dollar of tax reduction.

Now you speak of two or three billion dollars of tax reduction, concentrated in the below-the-$10,000-a-year-income group.

I have looked very carefully at a great array of budgetary data that has been gathered over the years by private and public agencies.

I have looked at the very fine data that the Department of Commerce has provided for us and have also looked at similar information from other countries.

From that investigation, I would have no reason to doubt that 2 or 3 billion dollars for its size would have very considerable potency.

I would think that one might, for a guess, expect on the very first round, some 80 percent of that to go into extra consumption, and that is only the very first round effect, and so although one should never think that we have a secret of perpetual motion and that $1 will do the work of a million, or that 2 or 3 billion dollars will do the work of 20 to 30 billion dollars, a careful study of all the factual data that we have gives no rise to particular despondency or pessimism over the potency of each dollar of tax reduction.

Mr. SCHMIDT. I would add that if the economy were honeycombed with serious maladjustments, this might cushion decline, if the maladjustments were all-pervasive an if we had a weak banking system or wrong monetary policy, it would cushion the decline moderately, somewhat as Mr. Stein suggested, but it would not hold us from going into a deeper recession.

I think the other point has to be emphasized, and I have 2 or 3 quotations in my statement that I made this morning—I think most economists would say that if concurrently you can also revive investment or maintain investment then you have really got the key to the prevention of the downdrag.

Senator GOLDWATER. Do you think that consumer spending itself, a spurt of consumer spending of 2 or 3 billion dollars injected into the consumer streams, would revive investment spending?

May I add to that, if it would how long do you think it would take for that to occur?

Mr. SCHMIDT. I would think it would depend upon how durable the investment fraternity and the entrepreneurs regarded that spurt.

If it was something fundamental, that was here and going to continue, and through the rollover, or the multiplier effect, or whatever Mr. Samuelson was referring to, if that were to continue I think it would foster increased borrowing and increased equity capital of available to go down the investment channels and create capital.

I don't think you can isolate a question of that kind, apart from all the other things that govern our economy, including this vague thing we call the business climate or business confidence, the prospects of peace, and all these factors are important and no one is exclusively important.

My own view on this question of consumption is a little different from Mr. Ruttenberg's. I have found it most helpful to assume that by and large the consumer in our type of economy will spend his income.

In fact, I define business confidence as the conviction on the part of businessmen that people will spend their incomes promptly, and so long as businessmen are on their toes and constantly developing improved and better products and new products, I do not think that our economic system ever generates a deficiency of consumer demand, and with the growth in research that Professor Samuelson emphasized in the development of new products, improved product—not simply gadgeteering, but improved automobiles, better housing, etc., I can't conceive of us facing at any time in the near term future any deficiency in consumer demand, either in terms of intent to buy, desire, or in terms of purchasing power.

Mr. RUTTENBERG. In the fear that a general statement from a person representing a labor organization might be misinterpreted, I have continually tried to use as I move along, not my own direct statements, but quotes. Here again let me quote from the National City Bank News Letter of May 1955, which I think is quite pertinent to the remarks of both Dr. Samuelson and Emerson Schmidt.

This is a quote:

> Plans for investment specially the long-term plans refer not only to the optimism stirred up by the spurt in sales but the belief that conditions over an extended period will be favorable for the profitable utilization of the new facilities.

I think what we are saying here is that when you come to combine the concept of tax cuts, under $10,000, with, shall we say—I don't mean to be stirring up any political differences but shall we say the built-in stabilizers in the economy that were put in in the 1930's and the early 1940's such as unemployment compensation, old-age benefits, FDIC insurance, and all these put together, tend to create the atmosphere in which a 2 or 3 billion dollar tax cut could have very significant effects upon the economy.

Senator GOLDWATER. One more question.

Can consumer buying power be any greater than the total personal income of the country, regardless of whether you cut taxes?

Doesn't the total national income of the country indicate the total consumptive buying power of the country?

Mr. SCHMIDT. In one sense they are identities, but you can of course through credit expansion inject additional previously nonexisting buying power, which may have price effects or it may have production stimulating effects.

It is a very complicated area in economics, so probably my colleagues think this is oversimplified.

I don't think they would disagree with the main point. In World War II we generated a lot of buying power by deficit financing, which did not previously exist, and it had price effects as well as stimulating effects on the economy.

Mr. DAVIDSON. Just back to your original question if I may for a moment, Senator, of course I would agree that any tax reduction under any circumstances would certainly have some beneficial effects as far as the private economy is concerned, but that largely nevertheless tax reduction of a couple of billion dollars designed primarily to benefit lower income groups would not have really significant effect on the flow of consumer expenditures and I thought some figures might help the record in that respect.

Actually $2 billion a year would be less than 1 percent, actually only eight-tenths of 1 percent of the present total of consumer expenditures in the economy.

By contrast, $2 billion would be 7.2 percent of the investment in new plant and equipment in 1955.

Senator GOLDWATER. What was that figure?

Mr. DAVIDSON. 7.2 percent; or even more significantly, I was referring there to the $27.9 billion figure of plant and equipment investment which was current when these figures were developed, which of course includes replacement, which I think Mr. Curtis mentioned or you mentioned before, as well as net new additions.

These data indicate very clearly that at least 80 percent, perhaps a great deal more of current investment, is going to replace existing plant facilities at present monetary value, rather than in net new investment.

If you were to relate the same $2 billion to what we come up with in a net figure, we find $2 billion would be 35.6 percent of the 5.6 billion of net new investment.

Finally, an interesting figure is that the new corporate venture capital in 1954 which included retained earnings plus new equity issued on the market was only $9 billion.

Two billion dollars would be 22.2 percent of that figure. We think that tax reduction of the magnitude we are talking about here have really tremendous significance for capital formation, but relative in significance for consumption as such.

Mr. RUTTENBERG. The figures are highly interesting but I think considerably irrelevant, Mr. Davidson.

Mr. SCHMIDT. Shouldn't you add, Mr. Chairman, the multiplier effect of capital formation?

I think most economists would agree that additional consumption expenditures do not have a multiplier effect in the same degree as capital expenditures.

Professor Samuelson has done probably more work than any other economist in that field. Would you agree with that?

Mr. SAMUELSON. I should like to be able to, but if you mean an autonomous shift in the consumption level then I think those, too, are high-power dollars. An upward shift in the consumption schedule just like an equal autonomous shift in the investment schedule, would also have a multiplier effect.

The difference would be that in discussing the old investment multiplier people thought of movement along the consumption schedule. I don't wish to bore the legislators, however, with such details.

Senator DOUGLAS. It is not boring at all. It is extremely important. Excuse me, Senator Goldwater.

Senator GOLDWATER. That is all right.

Senator DOUGLAS. I always wondered why it was thought that investment had a multiplier but consumption did not have a multiplier?

Mr. DAVIDSON. I think there may be some light perhaps on that question, Senator, by considering Professor Samuelson's interpretation of why we may have had such consistent growth and have had only slight readjustments in the postwar period.

He attributes the growth to Government policies which tend to stabilize the economy. I think the more accurate interpretation of

the record is that it has been the rather strong and consistent investment in plant and equipment, capital formation as a whole, which has proven to be the real stabilizer in the economy and the multiplier as Dr. Schmidt has pointed out.

Mr. SCHMIDT. I think if you look at any local community such as Edmunton, Alberta, back in the 1910's, when we had that fabulous boom—it was going to be another Chicago—it was the inflow of capital that gave it the zip. Look at any community or any country, as long as you have a high rate of capital formation, you have a high rate of consumption, a high ate of reemployment or employment, and while no one would deny the importance of the interrelationship between consumption and investment, I think most economists would say that capital formation is a much more dynamic factor in stimulating employment, growth, and certainly in stimulating a higher standard of living.

Mr. SAMUELSON. I spoke a moment ago of my wish to be able to agree with Mr. Schmidt. I am happy to say that I am able to not disagree with Mr. Davidson. I at no place said that the remarkable progress of recent years was due to the Government solely.

I spoke of the favorable environment which I thought it had created. Now I happen to have a biological belief that it is a mother and father that produces offspring. I don't want to subscribe to any doctrine of parthenogenesis here, and I would be forced to disagree with Mr. Davidson, if he is bringing in a one-sided biological economic doctrine here.

I don't think we are wise enough to be able to resolve the separate effects of each. I simply wanted to call attention in response to Mr. Curtis' remarks of how creative activity, sound creative activity on the part of the Government, is far from being competitive with private enterprise but is reenforcing.

Mr. DAVIDSON. Might I comment?

Mr. MILLS. Yes.

Mr. DAVIDSON. I think there are considerable differences between the sciences of biology and of economics. I think all progress in the economic field starts with capital formation and I do agree that there are two things that are necessary in the biological field.

Mr. STEIN. I think there is some confusion about the multipliers.

I think the point that Dr. Samuelson is making is that both consumption and investment have multipliers in terms of their effect on total demand or total expenditures, but nevertheless, I would agree with Dr. Schmidt that there is a difference between them, that there is an obvious difference between consumption and investment if we are thinking in terms of the growth of the economy over longer periods. Investment does have an effect in increasing productivity and our total capacity to produce, which the consumption does not.

Senator GOLDWATER. That is all I have.

Mr. MILLS. The Chair would first like to congratulate the members of the panel on a very productive effort this morning. The information given the committee has been very enlightening.

As the Chair has pointed out in each of these sessions our interest in these hearings is to develop basic economic principles as a guide to tax policy for long-run economic growth and stabilization.

We are concerned with public policy for assuring a sustained rate of growth which will not preclude simultaneous increases in the standard of living.

In other words, we recognize that we can have a much faster rate of growth if we are willing to sacrifice current living standards.

We also recognize that economic growth is largely but not entirely a question of the amount of capital outlays.

Are those conclusions in keeping with the thinking of the members of the panel?

Is there any disagreement with those two conclusions?

First of all, that there can be a much faster rate of growth if we are willing to sacrifice living standards——

Mr. DAVIDSON. Mr. Chairman, on that point I would like to say, and I think Professor Fellner brought it out so well, that actually at current rates of capital productivity, any sacrifice of consumption is over a very short period of time, and essentially in no time flat capital formation will in and of itself produce greater consumption than simply concentrating on consumption at a particular time.

Mr. SAMUELSON. Did you say "no time flat"?

Mr. DAVIDSON. He used 2 or 3 years which in the terms of man's life and economic spans is a relatively short period of time.

Mr. MILLS. Within time periods; yes.

I am referring to that. Then the second, we also recognize that economic growth is largely but not entirely a question of the amount of capital outlays.

Do we agree that that is a qualification?

Mr. SCHMIDT. You would have to add the quality of the capital plus the management of it; would you not?

Mr. MILLS. Yes, but still you can have economic growth without complete reliance upon the amount of capital outlays. That is what I am saying. Is that right?

Mr. SCHMIDT. Yes.

Mr. MILLS. We agree that is right?

Mr. RUTTENBERG. I would make some refinements I think in both statements but in the concept behind them generally I would agree.

I think they tend to overstate the points.

Mr. MILLS. I am not attempting to overstate the points.

I am trying to find if there is a ground on which I, all of us, can agree, in other words, that we can have in this country a rate of growth that may, if we are not careful, produce adverse effects upon living standards.

That type of growth I assume none of us would want for any lengthy period of time, though we recognize that it may come in any period of growth for a limited period of time.

Is that a refinement?

Mr. SCHMIDT. You mean an undue proportion of income allocated to capital?

Mr. MILLS. Yes.

Mr. DAVIDSON. I would like——

Mr. SCHMIDT. I don't know of any such period but it could be conceivable.

Mr. DAVIDSON. I don't believe that would be a possible result if your tax laws were fairly balanced across the board and did not impede economic activity one way or the other.

Mr. MILLS. I have not mentioned tax laws yet. I was coming to that point.

I started off with two primary theses that I thought maybe we could agree on.

Now in your statement, Mr. Davidson, in your second paragraph on the first page, you alarm me a little bit as I proceed with my thinking on these two possible situations.

You say the goal of tax policy should be to raise the necessary revenues as equitably as possible by means of available tax methods, not to favor, nor to penalize.

To that point I find myself in complete accord with your statement, your generalization.

Then you go on: Not to encourage nor to discourage, and certainly not deliberately to influence the course of economic events. Mr. Davidson, if we develop broad principles for tax policy for economic growth and stability, would the subcommittee be running counter to your general views as expressed in that paragraph?

Mr. DAVIDSON. I think that any difference here, Mr. Chairman, is in the frame of reference.

Our consistent point of view is that unfair discriminatory taxes impede economic growth, and if you reduce those taxes, you have not provided an encouragement.

You have only removed a discouragement which already existed in your tax system. I think that a reduction in taxes that impedes capital formation would be highly beneficial and highly desirable, but it is a choice of words perhaps, but I think it is a concept.

The effect is not to simulate as such but to remove a barrier which the tax laws prevent doing what otherwise would have been done in the economy.

Mr. MILLS. Are you saying that tax policy for economic growth and stability should be neutral in its effects upon both consumption and investment?

That is the thing—it should not impede nor stimulate in either instance?

Mr. DAVIDSON. I think that is a fair summation, Mr. Chairman. That really is what we are trying to get over, that if we had a fair and equitable tax system, balanced cross the board, we would not have these problems.

If you would pardon me I would like to make a further comment on that if I might.

Mr. MILLS. I would like for you to discuss the possibilities of such a day ever being reached, along with your other comments.

Mr. DAVIDSON. Well, that is another question.

We don't think that the possibility that it might not be reached, I might add, is a reason why we should not strive toward such a goal.

Mr. MILLS. I agree with you in that observation.

Mr. DAVIDSON. I was very much impressed by some statements and I don't mean to take them out of context, by Professor Samuelson, in his original statement in which he said in effect that 10 specialists would probably go in 10 different directions, in deciding which way you use tax policy at a particular time, on the assumption that you do use tax policy to manipulate the economy.

Elsewhere he says that it is precisely because public policy in the tax and expenditure area is so complex that we find it absolutely in-

dispensable to invest thousands of man-years of scholarly economic research in these areas.

Then today he made the comment that no one can speak with assurance as to what should be done, again in this overall frame of reference of using the tax system to manipulate the economy.

Our thesis is that we should not use the tax system for this purpose. We should strive for that kind of tax system which would have the minimum effect on economic motivation, decision, and action.

In that connection we have here really a very delightful little quote. This is from the Economist, a little over my head at times but it is fairly well written, and over in Germany you know in the last couple of years they have reduced the top individual rate to 50 percent and public authorities are talking about reducing it further because it is obvious that the release of capital savings which has resulted has contributed to the spectacular growth of the economy in Germany; growth through savings rather than increase in money supply through the banking system.

A man by the name of Herr Abs made the statement—

A million taxpayers behave more sensibly than one public authority.

I think in essence that is what we are trying to get at. I think if you levy taxes fairly across the board and leave the economic decisions up to the taxpayers you will get a better result and don't have to worry about inflation and deflation.

Mr. MILLS. I do not disagree with the thesis that the constitutional basis of taxation is to derive revenues to meet expenditures of government but in the course of deriving expenditures to meet expenses of government it is impossible for a tax ever to have a neutral effect, unless you keep it at no rate, or a very insignificant rate, so therefore, as we proceed to raise revenues to meet expenditures of the Government, I cannot escape the conclusion that in that process, we do affect or influence the course of economic events.

Mr. DAVIDSON. True.

Mr. MILLS. Now if we are not deliberately to affect, or influence the course of economic events in tax policy intended to obtain the desired rate of economic growth and stability, then there will have to be numerous changes made in existing law, will there not?

Because one who takes the position, in my opinion, that taxation should not affect economic events, and should be used only for revenue purposes, would not support, for example, the various things that are in the Code, such as rapid amortization, which was put in there to effect an economic result, the new methods for depreciation, which were put in to accomplish an economic result, the dividend received credit provision, which was sold to our committee for the purpose of accomplishing an economic result—enlargement of equity capital versus borrowed capital—we would also find ourselves in disagreement with the incentive provisions of the law on percentage depletion.

We might find ourselves unalterably opposed to our 14 point differential in the tax for Western Hemisphere corporations, and certainly we could not go for the extension of that program to other foreign countries.

I wonder if actually you want to stand on the statement that you make in that paragraph I referred to, or if we should all of us at this

hour recognize that we must plan tax policy with respect to its economic effects, and therefore the influence that it has upon economic events, in order to bring to the tax policy those factors and facets that we want for economic growth and stability.

Mr. DAVIDSON. I can give a short answer, Mr. Chairman, which is that we think definitely that tax policy should be designed to minimize economic effects, and we think the economic effects are primarily in the righ rates, and that we minimize those effects by reducing the rates.

Mr. MILLS. You mean of course by minimizing economic effects, minimizing economic deterrents?

Mr. DAVIDSON. That is right, sir.

I do not want to talk too long but I think the various measures you mentioned for the most part have their foundation in considerations of equity or in good business accounting or in other things, rather than in a positive desire to stimulate the economy. In any event whatever effect they have in relation to the total tax system is primarily a reflection of the very high rates against which the "benefits," if you want to use that word, under these provisions of the law accrue.

If you did not have the high rates which in and of themselves are a discouraging drag on human incentive then these things would not be too important, particularly the stockholder credit.

I think the basis for that is entirely one of equity, the double-taxation issue and not primarily as a stimulant to economic progress.

Mr. MILLS. You are losing the vote, Mr. Davidson.

I didn't vote for it in the committee.

My good friend, Mr. Curtis, did but it was not sold to the Ways and Means Committee as a device to eliminate the effect of the so-called double-taxation dividend but it was sold to the committee for the purpose of accomplishing the economic result of increasing equity capital versus borrowed capital and it was said at the time that there was need for an increase of equity capital opportunities in the United States.

Mr. DAVIDSON. Well, Mr. Chairman, I agree that the effect of the dividend credit is to minimize some of the inherent restraints that were existent and from that standpoint if you turn it around it has been beneficial, but from my standpoint at least the main motivation for the credit was a matter of equity. I think it would be highly discouraging under present circumstances—though the credit is very small—but any talk or intention to remove or eliminate the credit would be highly discouraging to the investor group in America because they would interpret that as a move to further penalize them in the years ahead.

Mr. MILLS. Mr. Davidson, it has been my observation, if I am not interrupting you, that when we pass a tax provision the result of which is to minimize the tax effect upon one group, that with a continuation of expenditures and receipts of Government, it is necessary for us to transfer that beneficial change in one area to a loss of that take-home pay in another area.

Now, does that always follow when we do these things?

Mr. DAVIDSON. I am not too sure of your point, sir.

I would point out though that the entire progressive system——

Mr. MILLS. If we pass such a thing as the dividend credit provisions, for a very laudable purpose, of attempting to obtain more equity

capital financing, when we were told that additional equity financing is necessary, and then the result of our effort is merely to provide a reduction in somebody's tax, if the revenues of Government must remain the same, then isn't it necessary for Congress to obtain that amount of revenue from some other source?

Doesn't that normally happen?

Mr. DAVIDSON. Well, Mr. Chairman, we are talking about a period here in which we expect a budget margin for tax reduction, and I would point out again some of the magnitude involves—the progressive part of the tax structure produces only 16 percent of the revenue from the individual tax.

That is something like $4.7 billion.

In 1954, there was the reduction of roughly $3 billion in personal income taxes. I don't mean that it should have all been applied to reducing progressive rates but it is evident that if that amount had been or even a reasonable part of it had been applied to reducing the progressive rates that the beneficial effects in terms of reducing the discouragement of the tax laws would have been far greater than any indirect methods of tax relief.

Mr. MILLS. Mr. Samuelson, aside from the latter part of the colloquy between Mr. Davidson and myself, I wondered if I could obtain some comment from you on the early part of our colloquy. Do you have any thoughts to advance?

Mr. SAMEULSON. Yes.

Mr. MILLS. With respect to our observations and the answers?

Mr. SAMUELSON. In my prepared address, I tried to be very careful not to express any moral judgments of my own; not to let my position as an economist intrude into what should be the public's ethical discussion.

However, I take it as the A B C of economics, that with a tax system of the sort we have, or of the sort that we are likely to come to in the next foreseeable years, that different tax structures will have different effects upon the economy.

I tried, in as objective a way as I could, to indicate what some of the different effects would be.

I think the pursuit of semantic definitions of neutrality, and nonneutrality doesn't get you very far—you know one man's distortion is another man's return to equity.

The fact is that you gentlemen in signing certain bills, and in pulling this lever, and pushing that, are having profound effects upon the economic system.

Now as a good American pragmatist I think we ought to know, as best expert knowledge can tell us, what the various effects are likely to be.

When we have done that prosaic scientific test—I use the word "scientific," there still remains the preference that is guiding the American people, and it seems to me, they never shout out one answer.

You have to look into your own heart. You have to look into the pluralistic interests of a great nation and then you have to blend and compromise.

Well, it is pedantic for me to dwell upon these aspects, but that surely is the nature of the problem of political economy in the 20th century.

Mr. MILLS. Does anyone have any comment on that point?

Mr. Ruttenberg?

Mr. RUTTENBERG. I agree fully with what Professor Samuelson has said.

Mr. MILLS. I have a question to address to Professor Samuelson and Mr. Stein.

I want to divide the question into four parts. I don't want your comment on one without knowing of the other three. I gather from your papers in the compendium that you are in basic agreement, as Professor Samuelson put it, that we can have full employment and at the same time have a much higher rate of capital formation than we now have and can accomplish all this compatibly with a tax structure that redistributes income to low-income families.

You think it can be accomplished by having a low-interest-rate monetary policy, a highly progressive tax system, and an overly balanced budget?

Now I want to ask the four questions:

Doesn't the proposition assume that capital outlays are quite responsive to interest-rate fluctuations, and is this a valid assumption?

Doesn't it also assume that if we are at the same time to have a tax system that redistributes income to low-income people and a budget surplus, we will have to have relatively heavy taxes on upper-income individuals and business?

If both of these assumptions are correct, the proposition in effect says we will get a high level of investment from low interest rates, coupled with high taxes on business and well-to-do individuals.

I am asking that in a question.

So we might recommend next year if we act on the basis of this proposition that taxes be increased on corporations and high-income individuals, at least relative to low-income individuals, while the Federal Reserve acts to lower interest rates?

Those are questions, not statements of position. I want your comments on whether or not these conclusions result from your statements in your papers.

Mr. STEIN. Well, I am not sure that I have all four parts of your question clearly in mind.

I think Mr. Samuelson's proposition does imply that investment is quite responsive to changes in interest rates, and I would tend to agree with him on that.

I think the proposition that we can get any amount of investment we want combined with any amount of income redistribution we want really means less than it seems to mean.

That is, I don't think it can be interpreted as meaning that we can have as low taxes on the low-income groups as we would like—as one might like, or might specify—and, at the same time, have as high rate of investment as one might like, or specify.

Professor Samuelson has been very optimistic, but I do not think he has repealed the proposition that there is some limit to the total output of the economy and that the larger the share of that total output which is devoted to consumption the smaller will be the share available for investment. While we can, under his hypothesis, have a high rate of investment with a high rate of taxation on the upper-income groups, I believe that would have to be coupled with suffi-

cient taxation on the lower-income groups to hold consumption to a level which leaves enough of the national output available for investment.

Otherwise no investment, or otherwise not the desired amount of investment.

I think there is one point omitted in Mr. Samuelson's analysis on which I would place considerable weight, and that has to do with the quality of the investment.

I believe that by creating a sufficient Government surplus we could create the savings out of which some desired rate of investment could be carried on, but I think the character of that investment, that is, the quality of the investment, would be substantially different if it were financed by Government savings created by means of a surplus and high taxes than if it were created by private savings.

The component of equity investment in the total would be much larger if the savings were privately generated than if they were created in the form of a Government surplus, and I think the risk-taking character of the investment, the forward-looking and productive character of the investment, would be greater if it were financed by private saving rather than by a Government surplus. The rate of growth result from a given amount of investment, therefore, would be larger if it were created by private saving than by Government saving, or, to put the case another way, a higher level of consumption would be consistent with some given rate of growth if the investment were financed by private saving rather than by Government surplus.

Now I am not sure whether I may have answered all four of your questions, or four parts, but that is my comment on the general area you opened up.

Mr. MILLS. Mr. Samuelson?

Mr. SAMUELSON. I would like to say that there is no basic disagreement between Mr. Stein and myself. I had hoped that in the amplification of my prepared statement that some of these same issues would be brought to the surface.

Let me try to answer your questions in the order in which you asked them.

My view that monetary policy at times achieve effects blended with fiscal policy obviously assumes a certain potency of monetary policy. In my paper, I spoke of the height of interest rates. I also spoke of the availablility of credit. Now, I don't think it is simply a question of whether bank acceptances go up by one-eighth of a point. There also is the more basic question of the availability of money at posted rates.

I am prepared to believe that in the depths of a great depression, monetary policy can become rather impotent. On the other hand, we have not been operating near such conditions for a long time. I think if you add in the availability of credit, through admittedly it is a very difficult job to know how important it is, that monetary policy can do a great deal.

I want to add more than that, though—I didn't enlarge on this in my testimony, but I do not accept for all time the conventional tools of monetary policy, of Victorian England.

I think that we missed great tricks in the great depression. We simply suffered from weakness of management, and I mean this in terms of solemn prudence for the economy.

Take the problem of building. The level of housebuilding was so low all through the thirties. Now, if you, if Professor Fellner were to make a rational calculation, just what does real capital cost to the American economy, let's say, in 1936, what is the true and proper interest rate that an ideal capitalistic economy working ideally would charge, I don't see how you could get that up above 2½ percent, 2¾ percent. Some people more daring than myself would put the figure lower and as we know in many countries, the interest rate did go a good deal lower than our rates.

I am prepared to be corrected by the facts, but it is not my recollection that you could borrow in 1936 in any part of the country to build a house at 4 percent; a rate which apparently we considered prudent in the very zippy days of the postwar period.

I think we simply lacked the imagination to create the catalytic devices which will free private initiative, which will enable private initiative to work, and so I would, if pessimism on the score of interest rates and availability of credit through conventional channels was impeding the progress of the American Nation, I would begin to scratch my head, and I would be prepared to bet that we could find many instrumentalities—many of which by the way are today in contrast to the 1930's, considered completely respectable and everybody is for them.

Well now, that refers to your first question.

With respect to the problem of having a high investment economy, it is, of course, obvious that if you are as optimistic as I am and as I think Mr. Stein is, that at full employment something has to give. If you have more investment there has to be doing without in the consumption field.

Obviously we can't get all the investment we want and still have everybody driving around in Cadillacs, rich and poor. To get more capital formation we have to give up some consumption. But there is no reason why whatever consumption there is to be can't be divided up in any ethically desired way among high or lower income groups. I do believe in a high rate of capital formation, especially when I think of the national defense problem. And this does mean that in an economy where income is being distributed without too great dispersion, the primary doing without consumption has inevitably to come from the masses.

What I am disputing is what might be called a trickle-down theory, that there is only one way to get the abstinence. May I enlarge on what is in my mind perhaps in the form of a parable. I think of some of the so-called backward nations of the world. They have come to capitalism late. They don't seem to be imbued with the full capitalistic ideology, and I contrast that with, say, Victorian England when simple laissez faire was at its maximum. People said in those days if they were thoughtful: you can't make omelettes without breaking eggshells. We have a class of rich who are able by virtue of their richness to do the thrift, and to provide the capital formation.

If I were called by an underprivileged nation, I might say to them, "You know your anticapitalistic sentiments will cost you very dear in terms of future capital formation."

Yet, the answer so often comes back: "We simply will not go down that road. We will not depend upon a trickling down of 10 percent,

20 percent, of 50 percent, or even 60 percent of what is given to the wealthy classes for capital formation."

How then can such a nation advance? I am an optimist; but if I were a pessimist I would say there is no way out of the impasse. That may be the answer of history.

I can imagine though in some of these countries, and I see this happening perhaps in some of these countries, that the way the same thing will come about, the creation of real saving, is not via a wealthy class, some part of whose receipts go into thrift, but by means of a doing without thorough fiscal and monetary policies combined, giving the distribution of what consumption there is the shape that such nations legislate, and yet achieving the amount of capital formation which in terms of their rather poor levels of income, they feel they can afford.

That parable applies, of course, to no-named backward nation, but I venture to think that facts are facts and machines are machines, and eggs are eggs and omelettes are ometlettes—that purely in terms of objective analysis, something of the same thing exists in our present economy. And I spoke of the sobering responsibility which you gentlemen have upon your shoulders, whether you wish it or not, not to abuse the effects that yau can have upon capital formation and other matters.

Now, I return to the problem of the quality of entrepreneurship. I think this is extremely important and it world be a mistake to believe that one of the less-developed nations of the world just needs little bits of paper, little green amount of money, freed of all entrepreneurship. I think there has to be a picking of the fellows with good batting eyes with respect to the future. I think our present system, which relies primarily upon decentralized initiative, is excellent. I think it can be improved on by having even more decentralized initiative. I think that occasions may arise in the future when the system is temporarily not running so efficiently, when we'll find new creative acts of Government—and I don't think of these acts as something that are imposed by some outsiders upon ourselves. I think of all of us in the Republic as getting together and setting down rules of prudence upon ourselves.

Now, I would say that in the period from mid-1930 to well, through the thirties, and I include the years after March 1933, we were not pursuing optimally creative policies either in the private domain or in the public domain or in the cooperation between those.

I suspect that there is some creative evolutionary institution building with respect to the quality of entrepreneurship that we also can hope to have. We don't have to depend upon whatever history throws up in the way of entrepreneurship in any one period.

Over a time we make our own general environment and the rules of the game. Now, I am afraid I have lost your last question, which was about the specific tax figure for the following year?

Mr. MILLS. No. I say, if both assumptions in my first question are correct, the proposition, in effect, says that we will get a high level of investment, say, from low interest rates, coupled with high taxes on business and well-to-do individuals. Does that follow?

Mr. SAMUELSON. I have myself no positive recommendation to make that the present tax system should be moved further in the direction

of what is in simple-minded fashion called equity, nor do I wish to stress my belief that the rate of capital formation for national security purposes ought probably to be stepped up. That happens to be my private belief, but it is not as an economist that I hold that.

I wouldn't, therefore, wish to draw an immediate moral for this next year's budget; I did wish to point out that economic analysis is in a certain sense neutral between these conflicting things and if you give great emphasis to the proposition, for example, that you would like whatever consumption there is to be distributed more toward the lower-income groups—let's say those below $10,000 a year—then I think that a combination of easier monetary policy, or less hard monetary policy, because it may be that we are moving into a time of harder monetary policy than we now have—that that combination, combined with the present level of business taxation or even an increase in business taxation might be the way of achieving that particular end.

This is where the subjective factor comes in, as to just what you are seeking in ultimate ends; how much you are willing to pay for each of the conflicting major ends of policy.

Mr. MILLS. Mr. Samuelson, I was not raising the question for purposes of your recommendations. I am merely raising the question in order to get your thought as to whether or not these possibilities follow from the statements you make in your paper and the position that you take in your paper.

Mr. SAMUELSON. Yes, they do. I can answer that question very simply.

Mr. MILLS. I had just 1 or 2 more questions that I wanted to ask. If it is the will of the committee, however, to adjourn and come back—shall we go on?

Senator DOUGLAS. Yes.

Mr. MILLS. I want to get to our present situation, if I may, and attempt to adduce information from the panel as to what the Congress can do with respect to taxation in the present situation that will be best in the long run for purposes of economic growth and stability.

Mr. Stein has been questioned by Senator Douglas somewhat on the position of his organization with respect to a tax reduction in the coming months, but I am thinking more in terms of obtaining from you information now as skilled individuals in an individual capacity if I may. Everyone has had his say, it seems, today about the desirability of some type of tax reduction in the next year, and I heard on the radio last night that it is a foregone conclusion that Congress will reduce taxes in the coming session.

I hadn't talked to any Members of the Congress, so I was not as well-informed as this commentator, but he may be right.

We were told by one of the panelists earlier this week that there was no particular need, Mr. Davidson, for immediate tax reduction to implement capital investment on the basis of a survey that he had made; that there might not be sufficient accumulations at the present time for small business, but his surveys lead him to believe that there were sufficiennt opportunities under present rates of taxes for sufficient enlargements within the next few months ahead; it would not be necessary to have tax reductions to bring about greater investments.

There have been those who have contended that there is need, however, for a reduction in taxes in such a way as to avoid a gap occurring sometime during the course of the coming year between production and consumption, a gap which one of our panelists predicted might reach some three or four billion dollars.

In other words, there would be three or four billion dollars lacking on the consumption side to match production about summer of next year.

I wanted each of you to consider these possibilities. If there is in the cash budget during the coming fiscal year, beginning July 1 next year, a surplus of $3 billion, as some have predicted, for long-range economic growth and stability, what should the Congress do with that three or four billion dollars?

Should it apply all of it on reducing the public debt, should it apply all of it to larger Government services or new services, should it apply all of it in tax reduction to meet this gap in some way, if such a gap between production and consumption is to occur, or should the Congress proceed to utilize it on the basis of a combination of these possible uses?

I would like someone on the panel to proceed, if you will, to discuss that. What can we do now that will best promote economic growth and and stability in the long run?

Mr. DAVIDSON. First, I think I should make it clear that our tax policies are framed in reference to the administrative budget and not to the cash budget. Nevertheless, picking up your question in regard to a $3 billion surplus, I feel very strongly that if such a surplus develops in the administrative budget that it should be used nearly in its entirety to get a start toward reduction, and it is only a start after all, of the high rates.

As I have indicated before, we think that first emphasis should be given to reducing the rates which hamper incentives, and which impede capital formation, but our own proposal in that connection only involves a couple of billion dollars annually, and if there should be more available we quite vigorously believe that it should be used in bringing down the first bracket rate of individual tax.

Mr. MILLS. Mr. Davidson, that is the position, even though this other contingency may develop, namely, the gap between production and consumption in the United States, and not for immediate benefits do I raise the question, but what should we do now in the light of this development, if it occurs, for long-range growth and stability?

Mr. DAVIDSON. Well, Mr. Chairman, we feel quite strongly that tax planning really should look a little bit beyond next year.

Mr. MILLS. I do, too.

Mr. DAVIDSON. And we should begin to look toward a pattern of tax reduction which we think will be available out of the proceeds of economic growth as they apply to revenue. A pattern of tax reduction, which not only will immediately release, shall we say, the incentives and stop some of the harassment of capital formation that occurs in the economy under present tax rates, but that over a period of several years, we suggest 5 years, that the top rates be brought down to rather moderate levels. We believe that such a program if inaugurated would definitely have benefits initially; there would be greater encouragement for capital formation, not only because of the current re-

ductions but because of the prospect of further reductions over the period of years that was selected.

Mr. MILLS. Mr. Fellner, do you desire, or will you comment on the situation?

Mr. FELLNER. Mr. Chairman, may I first ask a question?

The 3 or 4 billions are a consequence of tax increases—not increases of tax rates but of revenues at given tax rates—exceeding whatever increase Government expenditures are needed in a growing economy, I assume?

Mr. MILLS. My recollection is that the panelist who suggested this surplus was thinking in terms of present rates of taxation, bringing in that additional amount of revenue over present levels of Government expenditures. In other words, he raises the point whether it is better from the viewpoint of long-range economic growth and stability to raise expenditures to absorb that increase in revenues, whether it is better to permit that increase in revenues to apply on the public debt without increased expenditures, you see, whether it is better to use it as a tax reduction for the coming year, or whether it would be better to apply a part of it on all three of the possibilities.

Mr. FELLNER. Well, for 1 year, this is, I think, very difficult to answer although I am sure it would be very important to answer it. We don't really know what the business conditions will be in the fiscal year 1956–57, and my own feeling is that it would be very good to postpone this decision until we know a little more about that, unless this is technically impossible but if the decision could be made late in the spring, it presumably would be a better decision than the decision which could be made right now.

After all, there is 6 months difference there, and we will have a better forecast of what the presumptive business conditions will be. I think that if we have reason to believe that the Federal Reserve finds it difficult to maintain the inflation front, the anti-inflation front, then it probably would be best to accumulate a surplus in that fiscal year.

On the other hand, if business conditions are getting a little softer, then I think it would be better to reduce taxes, and I think that this is what should decide the issue: Whether at the time when it is necessary to make the decision, when it cannot be further postponed, the best guess is that we are going to face inflationary pressures in that fiscal year, or whether the best guess is we would want to sustain demand.

In the long run, at given tax rates we presumably would be raising our tax revenues by these $3 or $4 billions each year, if we move along the trend line, along which we hope to move, and I find it difficult to imagine that in a thus rapidly growing economy, we could hold any part of the GNP, including Government expenditures, constant on one given absolute level. I would imagine that there will be in the secular long run a rise in certain nondefense expenditures, even if we should find that the foreign policy experts are right in maintaining that we don't need an increase in defense expenditures, and, of course, about that we know very little.

This seems to be an assumption of it. Defense expenditures will be held at a constant absolute level, but whether in the long run this will be so, is a matter for others to decide. Even then a growing economy will need a gradual rise of Government expenditures, although not at

this rate, unless the foreign situation calls for it; not at the rate of an additional 3 to 4 billions each year, but some of this will be absorbed in the long run by increasing Government expenditures and some of it, I think, should go to reduce tax revenues; I suppose a substantial proportion to reduce tax revenue.

Mr. MILLS. I doubt that I have made myself completely clear as yet in what I am endeavoring to obtain from the panel, and that is an evaluation of what the Congress should do if certain contingencies arise: (1) That there is this $3 to $4 billion surplus in the cash budget; (2) that there is this gap of $3 or $4 billion between consumption and production arising, you see, sometime during the course of the coming year—an equivalent gap in consumption and production to the surplus in the cash budget.

Now, what would be the best thing for the Congress to do under those circumstances in the best interest of economic growth and stability?

Mr. STEIN. It isn't clear to me at least what the direction of this gap is between consumption and production.

Mr. MILLS. Consumption is under production.

Mr. FELLNER. Then my own reaction to this question would be in the circumstances in which we are likely to live over the next few years, we can increase effective demand by increasing investment as well as by increasing consumption, and that that discrepancy is not really between production and consumption, but presumably it is a discrepancy between production and the total effective demand, which will include consumer demand and investment demand, and I would not really be scared of working on the investment side of it. In other words, if we reduce taxes that impede investment, if we increase investment beyond the level at which it would otherwise be, I think we can eliminate that gap as well as if we increase current consumption.

Mr. MILLS. But Dr. Fellner, understand, the Congress should be concerned about the gap if it does occur, between production and consumption, and the Congress should then attempt to do something about that gap out of this surplus that may occur in the Treasury at the same time.

Mr. FELLNER. I think that the Congress could eliminate that gap between productive capacity and effective demand, or am I wrong in that assumption that this is the gap we are talking about?

Mr. MILLS. That is right.

Mr. FELLNER. I think the Congress could eliminate or contribute to eliminating that gap between productive capacity and effective demand by increasing current investment expenditures, as well as by increasing current consumption expenditures.

Mr. MILLS. Regardless of how it could be done, the Congress should not remain unconcerned and inactive with respect to the gap; is that the point?

Mr. FELLNER. Yes; if I understand your question correctly; the diagnosis on which I am expressing these views, the diagnosis which really maintains that the given tax rates we are heading toward an insufficiency of effective demand relative to productive capacity.

Mr. MILLS. Yes.

Mr. FELLNER. If that is so then I think taxes should be reduced, and I think that it is possible to remedy the situation by giving investment further stimulus, as well as giving consumption further stimulus,

except, of course, if we get into an acute cyclical contraction. That is a different sort of situation but I would not anticipate that.

Mr. MILLS. I don't want to belabor the point but I am trying to get a complete understanding. What you are saying is this then: that we should use all the $3 or $4 billion surplus, that amount which is necessary in tax reduction, either on the consumption side or the investment side, to equalize demand with production?

That would be the thing that we should do for long-range economic growth and stability?

Mr. FELLNER. Yes; for long-range economic growth and stability I would say that some allowance should be made also for such increase in capital formation as has to take place in the Government sector.

Mr. MILLS. Yes; that would be considered, of course. That would have to be.

Mr. FELLNER. I think that would absorb, probably, only a minor part of this yearly growing surplus which would take place at given tax rates.

Mr. MILLS. Mr. Ruttenberg, would you comment on your conclusions as to what the Congress should do under these circumstances?

Mr. RUTTENBERG. Taking these circumstances which you set forth as the existing situation, I would reason as follows: The announced intentions of business, as indicated by McGraw-Hill and the Security Exchange Commission, and others for business expenditures for plant and equipment are already high. They will set new records in 1956 if business intentions persist, and if there is to be a $3 or $4 billion surplus, this would encourage business even more to really carry forth its previously announced intentions of investment.

Regardless of the level of tax rates, regardless of the present tax situation, business will be investing $33 to $34 billion if present expectations hold in the year 1956, because that is, I assume, part of your assumptions. I would say that the $3 or $4 billion surplus that will exist should be applied to reducing the gap between the effective levels of production and consumption and that this could best be done by directing the tax cuts to the area of individual income, mainly, I would recommend, through exemptions. If the exemption levels were raised to the extent of taking up the $3 or $4 billion this it seems to me would result, in combination with increased business investment, in the kind of stimulation to the economy in terms of growth that would enable the Government to also simultaneously commit itself to increased Government services, without running a deficit and without necessarily running a serious deficit in fiscal 1957.

Mr. MILLS. Mr. Ruttenberg, we couldn't enlarge upon those services to any great extent, under the circumstances I have described, and reduce taxes at the same time without incurring deficit financing; could we?

Mr. RUTTENBERG. Well——

Mr. MILLS. That is, on the basis of the situation that I described?

Mr. RUTTENBERG. Let me just amplify a little the proposition: If business investments are going to reach the anticipated level, and if there is a gap between production and consumption, and this gap would be reduced by increases in individual income tax cuts through raising exemption levels, the combination of increased consumption

resulting from the tax cut, plus the existing anticipated levels of business investment, would combine to stimulate the growth in the economy, so that the total revenue resulting to the Federal Government would increase. Thus out of the increased total revenue, anticipated increases in Government service could occur.

Mr. MILLS. You anticipate, therefore, if the Congress would follow the course of action you suggest under the circumstances I have described that you would maintain existing levels of economic activity, or perhaps even have rising levels of economic activity?

Mr. RUTTENBERG. Rising sufficient to permit the Government from its increased revenue to enlarge Government services, for schools, roads, and so forth.

Mr. MILLS. You have that economic growth that is desired?

Mr. RUTTENBERG. Yes.

Mr. MILLS. Mr. Samuelson?

Mr. SAMUELSON. I should first like to stress that I would agree with some of the other members of the panel in saying that any decision with respect to taxation should be delayed as long as possible. I tried to think as you asked your question of the circumstances under which, by next March or April or May, one could know that we were going to have a cash surplus of $3 to $4 billion, and could also know with some conviction that there was likely to be a deficiency of effective demand of the order of magnitude of a few billion dollars, and I must confess that it isn't very clear to me that the future history is likely to run that way; that you would know those two facts simultaneously. But I am willing to answer an "iffy" question in an "iffy" way.

I would say that if there are signs that the production index is slipping, the amount of unemployment is going up more than seasonally, without regard to the fact that the cash surplus happens to be $3 to $4 billion, that would be a signal to you that on the fiscal and monetary front you should be acting in an expansionary direction.

Now, it is all the easier, I suppose, in terms of politics if you can be giving away a surplus rather than be creating the same thing in terms of a deficit, because there still is the notion that somehow that surplus is unnecessary.

I tackle then the problem of how to—I won't say squander the surplus, but how to utilize the surplus so as to fit a recognized shortage of effective demand.

I happen to think as a private citizen that there are many areas of defense where we are spending too little. I think on many occasions we have cut down on our defense spending or scaled our plans down not because we had a genuine feeling that tension had decreased, not because as an actuary we could say the chances of our children and wife being safe in the future had improved, but rather because it was thought in some sense the economy couldn't afford the defense load we had been spending. Let me take an example: Take the problem of continental defense. I don't come to you as a military expert. But imagine a people who had new cars all the time, and yet lived on the edge of a volcano which, by investing a considerable amount of their high earning, they could seriously reduce as an impending danger to them.

I frankly look upon the American people in that situation. I would gladly replace my cars less often than I thought prudent if I could invest that consumption in getting a much better continental defense system than we have.

You can go through the Military Establishment and I venture to say that we have not cut fat without touching muscle, in every area, and that in not every case has our reduction in expenditure been in terms of a prudent military man's appraisal of the danger, but rather in the belief that we were realizing some notion of orthodoxy, in finance. So the first thing I would do with part of those billions of dollars would be to take another look at our Defense Establishment and spend some of that in that direction.

With respect to the normal activities of government, I think if you examine the prewar and compare that with the present, you will find that there has been quite an attrition of the normal rates. We have new cars and we have crowded roads. I don't at all agree with Mr. Fellner's econometric projection that in all likelihood the future is going to bring us more tax revenues relative to the need for new governmental expenditures. I think there are many areas that we will be needing for Government expenditure and so I don't see the automatic surplus and deflation that he does.

There's the low-income family group—the problem now is not the third of the Nation any more but it still seems to be about a fifth of the Nation. And so there are many public services, I think, that need to be expanded.

This is, by the way, just what every family does. If you get an increase in income, you spend part for food, you spend some for recreation, some for tobacco, some for clothing, some for various governmental services.

The same budgetary laws that hold with respect to individual consumption in the private domain I think a rational people probably will want to have held in the public domain. So part of the surplus I would spend in needed public services. I think we have lost a little on road and school programs. The search for clever gadgets that fooled nobody has lost us a year.

There is the further problem, How much tax reduction and what tax reduction? I think that the occasion for structural reform in taxation should come from the cyclical climate; and under the hypothesis you made the cyclical climate would permit tax reduction. Six hundred dollars for an exemption level seems pretty low. It gets lower with every passing year. It is much lower really in real purchasing power than the worst of the war when we had $500. I would think, not because Mr. Ruttenberg believes that that is the way to salvation, of filling the deflationary gap but just because we need a structural form in that area, that there ought to be some low-income tax reduction.

I wouldn't feel too badly if the corporate tax rate went from 52 percent to 50 percent. I think that there is accumulating evidence that the corporation is a very good pooler of risks and if you provide proper averaging devices and tax offsets it is much more neutral with respect to venture investment than some of us have feared earlier; so given the current strength of investment, unless you want as part of your hpyothesis to make the deflationary gap come from some precipitous

decline in investment I would be inclined to think that the next 6 or 8 months does not in a mandatory way call for downward revision in the business tax area, generally.

Mr. MILLS. Does it not likewise call for a downward revision within the next 6 or 8 months, in your opinion, of the personal tax, aside from the assumptions that I gave?

Mr. SAMUELSON. Leaving aside the assumptions that you gave it seems to me that the first 6 months of 1956 will have to look a little bit like the first 6 months of 1953.

I try now to think of what retrospective wisdom we might have had in 1953 to have seen the recession of 1953–54.

Now, it may be that people with very keen eyes, would have had the farsightedness to have prepared then. I suspect that in the first part of 1956, it may look the same. That is one reason why I want to defer the decision.

Events clarify themselves in the economic domain. A man's opinion that the next 6 months this will happen, and then he thinks after that, that will happen, has unequal weight.

The first part of his opinion, probably according to recent history is likely to be right. The last part is mostly just idle chatter, so I would put off the decision. I think of the similar problem that the Chancellor of the Exchecquer, Mr. Butler, had just before the last elections in Britain.

He gave a tax reduction. It was before an election time, a very popular thing to do. I don't think its effect should be exaggerated; it didn't seem to work in the wrong direction from his viewpoint, but events catch up with you. Election day is only once in 4 years or so, and subsequently he has found it very embarrassing and there actually has had to be a backing up on that.

Now, I would hope that in the American scheme we could introduce the flexibility of the autumn budget. I think if things still look very strong in April, all politics aside, one needn't say, "Now, we reduce taxes or there won't be another chance until the following April."

I think we should be prepared to come back in the fall, and legislate emergency legislation if emergencies call for it.

I have no firm opinion about the last 6 months of 1956. I am an agnostic, but I think that probably means that I am a little more than agnostic. I don't think the betting odds are strong that we will have sizable recognizable collapse, or a significant recession. In any case, these events always cast their shadows before them to some degree, and we will know much more in April than we know in December.

Mr. MILLS. At any rate, you are saying in part there is nothing now from an economic point of view in your opinion that justifies an overall reduction in revenues of Government within the next 6 months.

Mr. SAMUELSON. No. On the contrary. I was a little amazed at the CED's optimism with respect to where the burden of proof stands on tax reduction. I should have thought that the same kind of agnosticism which I have expressed here, coupled with the actual behavior of industrial prices—this has been masked by the upward movement of farm prices—would suggest we already are in much more inflation than existed during any time of the hard money crusade of the first part of 1953.

I looked at spot prices in that period. I saw no inflation. I looked at the future prices, I saw no inflation. At sensitive prices. I saw no inflation. I looked at overall wholesale prices and saw no inflation in that period. If you consider the inflation sensitivity that so many people showed at that time, I would think that the present time should be giving them much more concern. And so I look with some apprehension on the behavior of the wholesale price index in the months ahead: it might edge up.

Mr. MILLS. In the interest of long-range economic growth and stability, you don't reduce taxes when you see possibility of inflation?

Mr. SAMUELSON. No.

Mr. MILLS. Mr. Schmidt?

Mr. SCHMIDT. Well, I do not want to take a lot of time.

I agree I think in general with Mr. Fellner and Mr. Samuelson.

I think it all points up that taxation is something of a blunt instrument, partly because you have to make a decision once a year, whereas monetary policy is so much more flexible.

Mr. Samuelson, I think misspoke himself a moment ago when he talked about the Federal Reserve deciding on monetary policy for the year ahead.

It never has to decide for the year ahead forunately, and in this respect, I think it bears out a little bit, although I do not agree with everything Mr. Davidson said, it bears out a little bit the point he was trying to make, that taxation is something of a blunt instrument, particularly in terms of timing.

I am bothered a little bit about your model. I don't think it has all the components in it.

Insofar for example, as taxation is current, pay as you go, it would be a little difficult to see how you could have this alleged deficiency of total demand and still have the tax figure so highly buoyant.

If there was a decline in current activity it would reflect itself with tax declines or at least accruals.

Mr. MILLS. I had the same impression, but I was stating an assumption that was offered here earlier by other panelists.

Mr. SCHMIDT. I think it points up the point I am trying to make, and that is that there are some components missing in the model as you tried to state it briefly and I would say that I would certainly try to employ monetary policy if this thing were coming over the horizon, and Mr. Samuelson is right that we can see these things coming.

I would first try monetary policy, and then fiscal policy.

If we are under inflationary pressures I would certainly think applying the surplus to debt reduction is the right thing, but apparently in your model there will not be inflationary pressure because you have assumed some kind of a gap in the total demand, so probably prices are under downward pressure. Then I would say that probably that is the wrong time to try to repay the debt, but it would be the right time to cut taxes.

In this sense I agree very much with the general conclusion of Mr. Fellner.

Mr. MILLS. You understand, Mr. Schmidt, that that is not the gap I have assumed from my own studies, but that is a gap postulated by one of the panelists appearing before the committee.

I am merely trying to get the opinion of this panel wtih respect to what we should do if these things should develop.

Mr. SCHMIDT. I think you have a more difficult job than the Federal Reserve has in this field because of the timing problem.

Mr. MILLS. They do not have their constituents looking over their shoulders as we do to see exactly what we do at all times with respect to their pocketbooks.

Mr. SCHMIDT. They are under criticism too, but I think they have more flexibility.

Mr. MILLS. I question whether they are under the observation.

Mr. Stein?

Mr. STEIN. I find it somewhat difficult to answer your question, because it includes an element which is quite foreign to my own way of thinking about this problem.

That is, it includes the assumption that at some point we know that there is going to be a gap of three or four billion dollars between total demand and total production, which is something less than 1 percent. Your question assumes that somebody has estimated confidently within 1 percent what total demand and total production will be.

On the assumption that the existing tax rates would give us a surplus of three or four billion dollars in the cash budget, and being either in the condition you postulate, or of not knowing, which I think is the more likely condition, I would favor a reduction of tax rates sufficient to balance the cash budget at high employment. That decision in my view would not be contingent at all upon this estimate of the gap unless the estimate were much larger and much clearer than either you have stated or I would think probable.

I think that the basic problem in this whole area is deciding what to do when you do not know what to do and when you don't know what the economic outlook is.

There is need for certain principles or rules of conduct that can be applied in that situation.

I think the principle of setting tax rates so as to balance the cash budget under conditions of high employment is, for various reasons, a very satisfactory rule.

It is the kind of rule which commands acceptance and is likely to be adhered to.

It is the kind of rule which sets limits which serves to promote economy in Government expenditures by keeping constantly before the public and the Congress the idea that if they do increase expenditures, that has a certain cost to the Nation which has to be met in some way, and brings home in these considerations the balancing of the costs and benefits of the expenditure.

Therefore, I would adhere to, or recommend adherence to, the proposition that we set tax rates high enough to balance the cash budget under conditions of high employment, unless there is clear and serious evidence of real inflation, or dangerous depression, and if the evidence were on the side of dangerous depression, I think that would call for a larger tax cut than would balance the cash budget.

I am assuming that this surplus is a surplus over expenditures which have been decided in some way are important expenditures to make, and that there are not other very compelling expenditures omitted from the budget which ought to be included.

Therefore, I would not disagree with Mr. Samuelson's proposition, that if it were true that an increase in military expenditures would add substantially to our security, that that ought to have priority over tax reductions.

As to the form of tax reduction, I believe here in a way Mr. Samuelson's law of a little bit of many things applies.

I would hope that the tax reduction could be in the direction of the kind of structure we would like to have permanently to live with.

I would believe that ought to include something on both the corporate and individual income-tax fronts, and if possible, something on the excises.

Mr. MILLS. Thank you, sir.

Mr. Curtis has a question.

Mr. CURTIS. I hate to at this late hour but I must not allow this discussion to end without posing this question:

Before other panels, where we were discussing inflation in more detail, I drew out the point that inflation, not in itself or the orthodox sense, but with the net result of getting money out of the pockets of the people and into the pockets of Government, was a form of taxation. I do not want to get into the equities of this thing but I do want to observe that the large group of people who were hit the most by inflation in the form of taxation were the older groups on retirement, and so forth, widows with children, and that group of older people which of course under our medical advances is becoming larger and larger. And I might state because they are living longer their fiscal problems are becoming greater.

This is the question as far as taxing is concerned.

Whether or not, by using any surplus to reduce the debt, which in turn would have a deflationary effort, or let's transpose it, would tend to, if handled properly, lower the consumer price index.

That would be a method of getting money back into the pockets of these people, which in effect for them would be, if that syllogism is right, would be a form of tax reduction.

Of course using Mr. Samuelson's term, "ready spending income groups," that certainly would be getting money to that lower—that ready spending income group—that would do that, but what bearing would that form of tax reduction, if it is feasible, have upon our economy?

Maybe the the syllogism is wrong. I am saying, use your surplus, and payoff on the Federal debt, which simply means you are going to refinance, because that would be the technique of handling it, but assuming that through that releasing of pressure, the price index would fall, and I might add this too, that wages and salaries would be maybe retained, this all coming out of increased productivity.

What would that do?

Is that a feasible method of absorbing this 3 billion?

I am mainly directing it to Mr. Samuelson, because I was following some of his remarks.

Mr. SAMUELSON. I am not sure that I understand the question but I certainly wish to underscore my agreement, that an increase in the price level is itself a very powerful form of taxation, particularly upon individuals with fixed incomes, and it may well be that as we pursue the goal of a rapid rate of progress, in terms of capital formation, and as

we pursue the goal of a high level of employment—and we have been succeeding in achieving a high level of employment in the postwar beyond the finest hopes I think of economists prior to the war—as we pursue those goals it may well be that there is an upward bias in the cost-of-living index.

So each man when he is 25 and each woman who is putting aside a little money for old-age retirement can perhaps not prudently look forward to receiving at the age of 65 that original number of dollars, plus the interest yield on it, in real purchasing power.

This I think has very powerful implications for trusteeship, for the forms in which pension-funds investment will have to take, and I venture to think it has very powerful effects upon the social-security system, and on an actuarially sound private security system. Let's suppose you had a private one in Germany in 1920; by 1923 that would be wiped out completely.

That of course was an enormous inflation. Not the sort of slow attrition that I am speaking of.

Well, now, under private actuarially sound systems that is the end of it.

On the other hand, in a social-security system, it is essentially the taxable capacity of the current generations of productive workers that everything depends upon, and the social-security system in Germany could start right all over again following such a terrible inflation, so I conclude from this that we should be alert and vigilant to raising benefit rates.

I will have to admit one caution though: This is one of those built-in destabilizers that at the same time that it corrects inequities for the aged and the fixed income groups, does to some degree add to the inflationary biases that is producing the whole problem.

I have no solution for that.

Mr. CURTIS. You are hitting right on the point and I am very much interested.

Your suggestion is that probably, although you recognize the technique of inflation, which in effect takes money out of this group's pocket, it probably could not be reversed, where we could, by lowering price index put money back in their pockets, because you come up with the suggestion that the way to do with it is just vote increased benefits, which is outside the taxing field of course.

I was just posing whether in talking tax reduction there was some way of doing the opposite of what we do when we take money out of a group's pocket during the inflationary period.

Thank you. That is all.

Mr. MILLS. I want to thank the panel again and to apologize for detaining you so long beyond the lunch hour.

The subcommittee will adjourn until 10 o'clock tomorrow morning.

(Whereupon, at 1:48 p. m., the subcommittee was adjourned, to reconvene at 10 a. m., Friday, December 9, 1955.)

FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

FRIDAY, DECEMBER 9, 1955

Congress of the United States,
Subcommittee on Tax Policy of the
Joint Committee on the Economic Report,
Washington, D. C.

The subcommittee met at 10 a. m., Hon. Wilbur D. Mills, chairman of the subcommittee, presiding.

Present: Senators Paul H. Douglas and Barry Goldwater, and Representative Thomas B. Curtis.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. Mills. The time has arrived for the subcommittee to come to order.

This morning's session of the Subcommittee on Tax Policy will be devoted to discussion of the economic impact of expansion and contraction of the tax base.

As was announced yesterday, our procedure is to hear from the panelists in the order in which their papers appear in the compendium.

At the start of each of these sessions panelists will be given 5 minutes each to summarize their papers. We shall hear from all panelists without interruption. The 5-minute rule will be adhered to and I have asked the staff to raise a card when the speaker has spoken 5 minutes. Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session. I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee's questions.

Our first panelist this morning, I think by arrangement of the panel, in view of the fact that his statement is generic, is Mr. Randolph E. Paul, of Paul, Weiss, Rifkind, Wharton & Garrison.

Mr. Paul, you are recognized for 5 minutes.

Mr. Paul. Mr. Chairman and members of the subcommittee: My paper, entitled "Erosion of the Tax Base and Rate Structure," is designed to raise the factual question whether our Federal income-tax system is as progressive as it is generally supposed to be. The answer I give to this question is that it is not.

In stating this conclusion I do not mean altogether to condemn the system because the real rates of tax are generally lower than the apparent rates as indicated in section 1 of the Revenue Code of 1954. This fact may explain one of the many mysteries of modern economic

life—why we have sufficient funds for investment to maintain the pace of our fast-moving economy. From this standpoint it may, therefore, be fortunate that the bark of our income tax is so much worse than its bite.

But I do mean to raise question about the discriminations put into the Federal income-tax system by a process of erosion both of the tax base and the rate structure.

That erosion has been going on for a number of years. The result of these discriminations is that the tax is not treating alike taxpayers who are in an economic sense similarly situated.

The tax has an uneven impact, and is more and more failing to do equity in a sense of even treatment of persons with equal incomes. Since, in the words of Mr. Justice Black, "uniform taxation upon those equally able to bear their fair shares of the burdens of government is the objective of every just government" (*Helvering* v. *Gerhardt*, 304 U. S. 405, 427 (1938)), this aspect of a growing failure to do justice among taxpayers should be a matter of intense concern to all of us.

By and large, I think that the discriminations in our income-tax structure work in favor of high bracket taxpayers. But many high income taxpayers are also caught in the web of injustice. This is because the discrimination is principally against taxpayers, small and large, who are self-employed, or whose income consists principally of salaries, professional fees, and wages.

This means that the injustice strikes at low income taxpayers earning wages and high income self-employed entrepreneurs, professional taxpayers, and corporate executives. This is because these taxpayers cannot take advantage of the opportunities for tax avoidance available to other taxpayers.

Also the discrimination is fundamentally against earned income. It may be growing to proportions which make the income tax a wasting asset of the Nation, and endanger the future of the tax as the mainstay of our Federal revenues. At the very least, it will arouse resentment and protest in unjustly treated taxpayers. This is an important consideration since we have a self-assessment system under which the success of the tax depends in large part upon the good will of taxpayers.

The principal item in proof of my conclusion comes from Statistics of Income, prepared by the Treasury Department. Under section 1 of the Internal Revenue Code of 1954 the marginal rates move up to 91 percent. The effective rates upon individuals with taxable incomes from \$100,000 to \$500,000 and above ranges from 68 percent to 87 percent.

The marginal rates range from 87 to 91 percent.

These are high rates of tax. On paper they look extremely severe. But the schedule in section 1 does not tell the whole story. According to Statistics of Income, page 9 of the preliminary report, the actual effective rate for 1952 upon adjusted gross incomes above \$100,000 was 53.4 percent.

The percentage for 1951 was 53.1 percent. (See Statistics of Income for 1951, page 97.) These average effective rates on all adjusted gross incomes from \$100,000 up to the highest level were about the same as the apparent effective rate on taxable income of only \$100,000.

If we add back to adjusted gross income for 1951 half of net capital

gains (eliminated in computing adjusted gross income) the average effective rate for 1951 goes down to 45 percent on taxpayers with incomes of $100,000 or more.

It would go still lower if we thought in terms of a tax on the increased wealth of taxpayers and included in increases of that wealth such items as exempt State and local bond interest, income rescued by percentage depletion, the undistributed earnings of corporations and some of the other items of wealth increase I have mentioned in my paper.

I list the causes in my paper and I won't stop in my summary to enumerate them.

They are on pages 300 to 303 of my paper.

On pages 300–303 of the report of the Subcommittee of the Joint Committee on the Economic Report dealing with Federal tax policy for economic growth and stability I list the principal reasons why most taxpayers pay income taxes at a lower rate than the rates appearing at the beginning of the code. These listed causes are.

1. The exemption of interest upon bonds issued by State and local governments.
2. The exemption of interest upon savings invested in life insurance.
3. The deduction for percentage depletion and expenses of exploration and development of mineral resources.
4. The deduction of certain personal consumption expenditures, such as real estate and other taxes, and interest payments upon owner occupied homes and upon consumer debt.
5. The permission given by the statute permitting splitting of income between husband and wife, and further splitting of family income by the use of multiple trusts, gifts during life, and family partnerships.
6. The sanction given by the statute of deferred compensation arrangements, pension trusts, and various types of fringe benefits.
7. The failure of the statute to tax adequately accumulations of profits in corporations.
8. The preferential treatment given by the statute to capital gains.
9. Inadequate enforcement, permitting evasion of the tax of many kinds, among which is the practice under which the owners of family businesses charge many personal consumption expenditures to business expense.

It would be presumptuous for one person to say just what the Congress should do to remedy the situation I have described. One basic point I make is that we should deemphasize the encouragement of investment and put more emphasis on the encouragement of consumption and the revitalization of equity.

Generally, I suggest two approaches to the problem. One is to continue the process of granting balancing favors to taxpayers who think they have not received their share. A more heroic remedy is to set about the elimination of the causes of disparity. This involves the removal of discriminations and special benefits and taxation of all dollars of income alike, from whatever sources they may be derived.

Of course, some special treatment is necessary for capital gains and losses. But the extension of this type of privilege to more and more types of income should cease. At the very least, we should

stop the process of erosion so that things do not become any worse than they now are.

Specifically, for our next tax program, I suggest a lowering of the unrealistic high surtax rates. This would give relief to high-income taxpayers who are unable to avail themselves of techniques available for avoiding the impact of the rates now appearing at the beginning of the code.

I also suggest the elimination of the dividend credit introduced by the 1954 code, a provision for withholding on dividends and interest, and a lowering of rates in the lowest bracket, possibly by a split of the first bracket. These specific changes I think would help to restore balance and equity to the statute.

Mr. MILLS. Our next panelist is Mr. Walter Blum, professor of law of the University of Chicago Law School.

Mr. Blum, you are recognized.

Mr. BLUM. Over the years our income tax has become one in which special preferential treatment has become the rule rather than the exception. We now have a large assortment of provisions giving preferences to particular kinds of taxpayers, to certain types of receipts to some categories of business expenses, to certain forms of personal consumption, and even to particular kinds of savings.

Mr. Cary in his paper has detailed these to some length.

The result is that it is very hard to compare the tax burdens of different people.

There is no general data on how this patchwork of special provisions affects the overall morale of taxpayers and their advisers. Of course the taxpayers who come out ahead as a result of their preferences are not likely to be unhappy about them. And there is little doubt that some preferences have wider popular appeal than others.

But the important morale question is how the whole network of preferences affects the morale of the taxpaying public. On this issue we are able only to form some partial conclusions.

We can be certain that the host of special provisions complicates the tax. This puts a greater load on taxpayers who make out their own returns and causes many to turn for help to advisers—ranging from fully qualified professionals to store-front tax experts who have sprouted up all over the country.

These self-styled experts often operate in a manner which is hardly calculated to improve their customers' respect for our income tax.

We know that the complications make the income tax less intelligible to taxpayers. There are signs that some people have come to doubt the fairness of the tax in part because they cannot understand it.

We are sure that the special provisions cause a great deal of time and energy to be spent in tax planning. Most of this is wholly unproductive and it often produces behavior which, taxes apart, might not be advantageous to the taxpayer or to society.

We have evidence that special provisions sometimes are temptations to loose reporting practices on the part of taxpayers and nonprofessional tax experts.

There is an understandable pressure to stretch preferences to cover one's own situation even when it falls on the wrong side of the arbitrary line by which the special treatment is defined.

We can be confident that the complexities accompanying the conglomeration of preferences have increased the difficulty of enforcing the tax. More taxpayers seek assistance from the Government; more mistakes are made in preparing returns; more chances are taken by taxpayers in interpreting the preferential provisions to suit their needs; and more unintended loopholes are unearthed as tax planning expands in breadth.

These handicaps to enforcement in turn are likely to cause taxpayers to run even greater risks in helping themselves to unauthorized benefits in computing their taxes.

Finally, we are becoming aware that the receptivity of Congress to special legislation has contributed to making competent tax advisers cynical about the justice of our system. Some have become special pleaders to such an extent that they are unable to identify themselves with the interest of the whole public in tax matters.

I might add in passing that Mr. Paul is an outstanding exception to this.

Not only is their usefulness in improving our tax system impaired, but their cynicism is easily caught by susceptible clients.

These are dangers to taxpayer morale from crisscrossing our income tax with special provisions. Whether they are offset by the good will and appreciation on the part of the beneficiaries of the preferences is an open question.

Certainly the advisability of any particular preference should depend primarily on considerations of equity and economic or social policy.

In this respect I agree with Mr. Paul. But the dangers pointed out should not be overlooked. While no single special provision is likely to produce them, a large collection of preferences is clearly capable of doing so.

In this connection I should like to emphasize what is perhaps most important is that almost every preference tends to breed progenies. If the history of special provisions shows anything it is simply this: Whenever a preference is given in one situation, there will always be taxpayers who can plausibly claim that their case is analogous and therefore also deserves special treatment.

And so in passing on the merits of any suggested preference, two general considerations are worth keeping in mind.

(1) A large body of special provisions might well have undesirable affects on the morale of taxpayers as a whole.

(2) Any body of preferences will always tend to grow unless the legislature has a strong policy against them.

Mr. MILLS. Our next panelist is Mr. William L. Cary, professor of law, Columbia University.

Mr. Cary, you are recognized.

Mr. CARY. Mr. Chairman, my paper closely parallels that of Mr. Paul.

Pressure groups appear to be active and effective, in the constant erosion of our tax system. The law is being riddled with special provisions while we preserve the fiction of uniformity. I believe there is a basis for alarm over this trend. There is a limit on taxable capacity, which is basically psychological and has been too long taken for granted despite its importance.

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Our fiscal system cannot survive unless the majority of the citizenry retain confidence in the equity of our tax system. Preferential treatment breeds disrespect for the revenue laws, and without respect there will be no effort made to abide by them. The efforts of pressure groups may take the form of a subsection, or euphemistically called technical changes—each difficult to detect.

However innocuous they may be individually, collectively they demonstrate an accelerating tendency toward preferential treatment. The Internal Revenue Code of 1954 has not altered this trend. To illustrate, let us take two revenue acts, of 1951 and 1954.

Special relief provisions for individuals and private groups have been reenacted and are firmly embedded in the 1954 code. Probably the finest demonstration of legislative tenacity, and of human incapacity to weed out laws once on the books, is section 1240, enacted in 1951 and popularly known as the Mayer provision in honor of the alleged principal beneficiary under it.

It bears the deceptively general title of "Taxability to Employee of Termination Payments."

As a general rule of taxation, any lump-sum distribution upon retirement is taxable to the employee and bunched in 1 year as ordinary income.

Yet to resolve this predicament in the case of one movie executive, the bill provided for capital-gains treatment, but only where the taxpayer (1) had been employed for more than 20 years, (2) had held his rights for future profits for 12 years, and (3) had the right to receive a percentage of profits for an extended period after the termination of his employment.

How many persons could such a restricted provision cover? Perhaps some kind of relief such as an averaging system is needed for bunched income generally, or for retiring employees, but is there any sound basis for the relief of one executive through capital-gains treatment?

A new case of congressional generosity in the 1954 code seems tailored to the needs of certain commission merchants in the South. Whether by custom or rules of the trade, a few of them are required to do business as partnerships although for tax purposes their preference would be in favor of operating in the corporate form. Their problem was considered by the Treasury.

In his budget message of 1954 the President recommended "that corporations with a small number of active stockholders be given the option to be taxed as partnerships and that certain partnerships be given the option to be taxed as corporations."

Section 1351 of the Senate bill provided that corporations could elect to have the tax status of partnerships under specified conditions. This might be justified in the frequent instances where partners incorporate to protect themselves from personal liability.

Section 1361 gave an option to partnerships (where capital was a material income-producing factor) to be taxed as corporations. The latter was described in the Senate report as "complementary to the similar option granted certain corporations," or as "the vice versa provision."

The first and more important section, section 1351, was eliminated in conference, but—though few were affected—the political pressure behind section 1361 was enough to effect its retention, thus retaining

the "versa" without the "vice." In other words, two provisions linked together were separated, and only the minor one—benefiting a handful—was ultimately enacted. This is not a sensible solution.

A major example of largess in 1954 was to provide capital-gains benefits to inventors and angels financing them. It should be noted, however, that the wishes of the patent lobby have not been fully satisfied. In the 1953 hearings the president of the National Patent Council urged that patents receive percentage depletion.

The benefits conferred upon inventors and their financial angels should be contrasted with the tax treatment of artists, authors, and composers. While many groups within our society (including a single movie executive) have become beneficiaries of amendments converting income into capital gains, the Revenue Act of 1950 administered the coup de grace to liiterary, musical, or artistic compositions by expressly excluding them from capital-gains treatment.

Why? Is it because America tends to favor material success at the expense of developing the arts? Probably the reason why professional men and artists are not receiving favorable treatment is a purely practical one. They are individualists, too scattered to represent an effective political force, and without a lobby dedicated solely to the cause of obtaining special tax advantages.

Full comprehension of the pressure for preferential treatment cannot be conveyed without consideration of 1955 and forthcoming legislation. Even before the President had signed the 1954 act, another tax bill had been referred to the Finance Committee and was reported favorably.

Congress adjourned before it passed. The amendments included by the Senate committee provided relief to one railroad (retroactive to 1941), certain trusts for military personnel who died in action, farmers selling livestock on account of drought, and other random beneficiaries. One of these has already become law.

Before analyzing further instances of congressional response to outside pressures, we should arrive at some preliminary generalizations from the preceding examples of relief. Being technical or incomprehensible to the layman, the provision is not recognized as an outright favor to one individual or highly selective group.

Moreover, the relief is not palpably unwarranted. The case involving the retiring movie magnate demonstrates one of the basic weaknesses in the tax system, namely, the taxing of bunched income where no averaging method is available. But this inequity affects a multitude of taxpayers.

The movie executive here is probably not injured as much as the actors who work for the same company. Perhaps all these cases warranted relief, but is it not true that the tax laws work hardship in an infinite number of transactions?

Can relief be scattered sporadically among a few individuals—whose only common characteristic is access to Congress—without making a mockery of the revenue laws?

For every person who successfully argues that he is discriminated against, there are thousands of others, inarticulate or ineffective, who are suffering the same fate in silence.

The code has also shown evidence of responding to pressures from industry groups. Of these, the oil industry has been the most fre-

quently commented upon. No attempt will be made here to repeat the criticisms leveled at the percentage depletion which oil enjoys. Only a handful of Senators venture to oppose it. In fact, one Senator urged his colleague to withdraw a controversial amendment by saying, "I am simply trying to keep (him) * * * from committing suicide."

I might say he is still in this room.

Several other extractive industries appear to have profited recently from effective lobbying: Coal in 1951, and also sand, gravel, and stone.

With respect to coal, the percentage depletion deduction was increased from 5 to 10 percent on the ground that the coal-mining industry was peculiarly in need of more favorable tax treatment because of the inroads which alternative sources of energy, particularly oil and gas, had made on the potential markets for coal.

Note here the inconsistent theories upon which the percentage depletion deduction was granted.

On the one hand, the intention is to stimulate exploration by awarding a tax advantage to the oil industry.

On the other, it is to furnish relief to an industry which has suffered by reason of the increasing use of oil and gas. If percentage depletion has any function in our tax structure, should it be used to encourage development of one and "bail out" another at the same time?

Another group which has been satisfied, after years of clamor over discrimination, may be referred to loosely as the sand and gravel lobby.

In 1951 almost every known building material received a 5 percent allowance for depletion. When Senator Douglas moved unsuccessfully to strike out clam and oyster shells, Senator Connally said in debate, "The Senator from Illinois does not have many in his district."

In 1954 allowances for granite, marble, slate, and other stone, when used as dimensional or ornamental stone, were raised from 5 to 15 percent. In order to draw some line, however remote, Congress in the new code expressly stated that percentage depletion does not apply to soil and water, or minerals from sea, water, air, or similar inexhaustible sources.

The foregoing illustrations of congressional responses to pressure from industry groups point toward the basis upon which tax relief has been granted. The formula in most cases appears to be the discrimination argument, the demand for tax equity.

Moving from the privileged tax treatment accorded to specific individuals and industries, let us now attempt a brief survey of some of the important economic groups in our society and how they are faring in the race for special benefits. Today the large investor probably constitutes the most important beneficiary of preferential treatment.

A Harvard business school study has reached the opinion that much of the income received by upper-bracket individuals appears to avoid the full impact of the income tax.

One chart indicates that in 1946 there was little or no progression in effective tax rates beyond the $50,000 income level.

This can be attributed in major part to capital gains.

Another, quite different, way of reducing the effective rate of taxation is through the purchase of tax-exempt securities and of insurance.

A further grant available to the large investor, percentage depletion, has already been discussed. Perhaps the most obvious benefit to investors is the new dividend-credit provision of the 1954 act.

Another group receiving special favor is the corporate executives, who have pension or profit-sharing and deferred compensation plans, perquisites—which are growing in number—and, finally, the stock option, which is available to the officers of large publicly held companies.

Because of the 10-percent limitation and the difficulties of ascertaining the value of the stock, such options are not found in small business, which would actually benefit much more directly from tax incentives given to management than do large companies whose stocks may fluctuate with the market generally.

Under the 1954 act, executives received a further benefit—any annuity or other payment receivable by a widow under a qualified pension or profit-sharing plan is now excluded from estate tax.

Owners of family businesses are another favored group. They can receive capital-gains treatment by holding on to their business, accumulating the earnings, and ultimately selling out.

They are—improperly in some cases—charging many personal expenditures off as company expenses. As in the case of executives, they may benefit under pension and profit-sharing plans and have the additional opportunity to split up their property interest over the family group.

Even farmers today have special tax advantages. According to one survey, only 36 percent of farm income was reported on tax returns. At the same time, they are not resting on their laurels, for the code now provides that income derived from disposition of livestock shall have the benefits of capital-gains treatment.

Senator George refused to include chickens in the Senate bill, but said, "Turkeys were included somehow, I do not know how."

The tax benefits derived by organized labor are not yet on a par with those of the investor, in part because the capital-gains provision is of less advantage to them, and in part because of the withholding system on wages.

At the same time, while decrying some provisions as loopholes, they are not unrealistic as to their own interest.

Tax considerations have played a major role in the current shift of collective bargaining from wages alone to fringe benefits, such as pension plans and payments in the event of retirement, layoff, accident, or sickness—all of which receive preferential tax treatment.

According to Professor Ratchford, we may be going through a development which is just the opposite of that which marked the end of the feudal period when wage payments were being commuted into money. Perhaps the time will come when the individual unfortunate enough to receive all his wages in money will have an impossible tax burden.

Finally, we come to the professional people who may be regarded as orphaned under the code. Their only benefit is the opportunity to spread an extraordinary amount received in any 1 year over a longer period. Yet, they are probably better off than movie actors and boxers whose earning power is telescoped into a few years.

Moving from the economic classes, we should note the increasing relief awarded to the blind and the aged. For some reason, the blind receive a special tax exemption, even though there are many more people totally disabled from other sicknesses, such as mental illness.

With exemptions and retirement income benefits, old people also are becoming increasingly favored.

Undoubtedly the aging of the population will broaden the erosion of revenue in the coming years.

Perhaps the general conclusion can now be ventured that the tax laws represent a patchwork of special legislation awarded on a random basis.

Part of the problem today is the general acceptance of a philosophy of taxation which attempts to justify a system of disuniformity.

Advocates of capital gains say that with rates as high as they are, holes in the code must be available so that someone can make a fortune. But should these holes be drilled for the benefit of those who can exert the most pressure?

Many of the special provisions owe their existence to the discrimination argument. Perhaps the principal point made before Congress is that, since one group in our society has received a benefit, the complainant deserves like treatment. The more preferential legislation written into the code, the greater the opportunity for others to claim they are being discriminated against.

The difficulty lies in finding, first, some logical basis for drawing a line, and, second, some political group supporting the policy of drawing it. There are very few organizations before Congress opposing further extension of preferential treatment. Perhaps we are gradually approaching the taxpayer's millennium, when all citizens have available the benefits of converting ordinary income into capital gains.

Now may I venture to make several suggestions, which can do little more than abate the fever, and not cure it.

First of all, I would favor the application of an averaging provision to a broader group of transactions.

At the outset it might be relatively simple, like section 1301 of the 1954 act which has for some years been applicable to persons in law, writing, and other professions.

Second, although elimination of every existing special provision is too much to expect, Congress should commence a rollback and strike out at least a few inexcusable sections as a symbol of its effort to hold the line.

Section 1240, involving the Mayer provision, and section 1351, favoring southern commission merchants, are but several examples.

Third, more information should be available to Congress, in the hope that it might act with greater watchfulness.

To reach individual Congressmen more effectively there might be separate technical staffs for the House Ways and Means and the Senate Finance Committees, as well as the joint committee staff.

A fourth suggestion stems from the fact that in congressional hearings there is practically no one, except perhaps the Treasury, available to represent the public.

Perhaps the reason is that all of the pressure-group proposals are of such character that no one of them would have a large adverse effect on the tax bill of any individual.

In order to obtain such a balanced view, therefore, it is suggested that several leading tax experts throughout the country be invited and retained to make a presentation before the Ways and Means or Finance Committees.

Mr. MILLS. Our next panelist is Mr. Thomas Atkeson, professor of taxation, College of William and Mary in Virginia.

Mr. Atkeson, you are recognized.

Mr. ATKESON. Mr. Chairman, traditionally, the taxing committees of the Congress have had to give practically all of their time to such matters as the distribution of the tax burden itself, and have consequently and understandably ignored many of the administrative provisions and features of the tax law.

As a consequence, many of the intended burden distributions that were written into the law have not been carried out in fact for the simple reason that the administrative provisions were not adequate to insure that the will of Congress was carried out.

The administration of a tax law involves many economic considerations, and I think, therefore, if I might say so, it is extremely appropriate that the taxing committees and this committee give consideration to the administration. I am very happy that you have invited me here to bring in a few of these administrative considerations.

I would like to say at the outset that I have about half a dozen suggestions which I won't try to work into this 5-minute presentation. I mention them at this time in the hope that I might be called on a little later to explain them, so at the moment, I will give you the summary of my paper, leaving the suggestions to a later discussion.

The economic cost of administering special tax provisions stems chiefly from the diversion of human energy from important to less important tasks.

The term "special" tax provisions is limited in scope to special situations and, therefore, is not applicable to each and every taxpayer. Nevertheless, the administration of special provisions requires that they be brought to the attention of each and every taxpayer, solely as a matter of honesty in administration.

The basic burden of getting the information across to each and every taxpayer falls upon the Internal Revenue Service, private employers, and other segments of the business community.

The time and money spent by the Internal Revenue Service, for example, in explaining that a son and stepson may be taken as a dependent as well as the descendants of the son—but not the descendants of a stepson—illustrates the diversion of energy from the important task of checking on substantial underreporting, to the less important task of explaining technical limtiations with little or no revenue consequence. For employers and other segments of the business community it is a diversion of energy from the important task of physical production to the less important task of aiding their employees in the minutia of tax return preparation.

Every dollar so diverted by the Revenue Service costs the Treasury a minimum of $20 in taxes due under the present revenue system but which will never be collected because of the inability to effectively audit more than 3 percent of the individual income-tax returns and 20 percent of the corporate income-tax returns.

Every dollar so diverted by employers and other segments of the business community costs the Treasury the tax attributable to such

dollar as it is an allowable deduction. Moreover, it costs the economy the value of the productive output of that dollar plus the added tax which would accrue to the added profits realize by such output.

More specifically, the following factors are among those which explain the economic costs attributable to the special tax provisions:

(1) The need to prescribe a variety of types of individual income-tax returns to fit particular groups of taxpayers rather than one type for all taxpayers results in much inaccurate distribution and wastage of blank forms because of taxpayer classification changes from year to year.

The number of tax forms printed runs about 5 to 1 actually used.

(2) The impossibility of providing adequate instructions results in much loss of taxpayers' time from work seeking assistance either of the Revenue Service, his employer, or a tax practitioner.

(3) The high degree of inaccurate reporting (as indicated by Commissoner Andrews) in certain areas results in added expense in money and time to the Revenue Service and the taxpayer.

(4) The resources of the Revenue Service devoted to assisting the taxpayer to an understanding of the special provisions could more profitably be applied to a more substantive enforcement of the laws.

(6) A long-continued policy of weak administration as indicated by the audit of only a small fraction of the returns encourages weak compliance with increasing tax losses. (Voluntary compliance has been described as a valuable national asset subject to depreciation unless kept in adequate repair through strong "administration.")

(7) Special provisions tend to cancel each other as they approach the lower brackets (such as any one of a group may be all that is necessary to render a return nontaxable without the need of the others) but accurate reporting requires the taxpayer to make a complete report, thus adding to his work and that of the Revenue Service with no difference in tax effect. (For 1952 there was 10.5 million nontaxable returns filed, which number will materially increase under the added special provisions of the 1954 Code.)

(8) The technicalities of the special provisions has added greatly to the printed matter privately published and sold throughout the country, which adds to the Nation's cost of tax administration.

(9) States which attempt to pattern their income-tax laws after the Federal law are hard-pressed to keep pace with the special provisions and further confusion and cost results either whether they lag or whether they keep pace.

Conclusion: Quantitative answers as to the economic cost of administering the special provisions are not possible to obtain with precision, but the evidence appears to justify the following generalizations:

1. The cost of reasonably complete administration of the special provisions for all returns would be prohibitive under our concept of good government, due to the excessively large number of Government agents that would be required.

2. The cost of the highly incomplete administration of today in respect to returns to which the special provisions apply is proportionately much higher in relation to the tax on such returns than on returns of other types; and in many cases greater than the tax.

3. Diversion of funds for the administration (although only partial) of the special provisions costs the Government much by way of revenue

through failure to make appropriate tax audits; and, the employers much by way of added production.

4. The administrative cost of administering the special provisions, although relatively small in relation to the job to be done, is sufficiently large to dilute the administrator's fire upon the main job and adds an element of inefficiency in overall tax collection with a resulting leakage which should be charged against the cost of administering the special provisions.

As to the suggestions I will be happy to comment on them later.

Mr. MILLS. Our next panelist is Mr. Harold Groves, professor of economics, of the University of Wisconsin.

Mr. Groves, you are recognized.

Mr. GROVES. Thank you.

Mr. Chairman, members of the subcommittee, in order to sharpen and shorten my remarks, I shall give them informally and stress two points.

The first is that tax critics frequently have a myopia, in that they do not appreciate that special concessions in the tax laws are not at the expense of an abstract thing we call the revenue, but at the expense of themselves.

This might be called the defeating-the-revenue illusion.

It has been calculated roughly—and I think conservatively—that if all the controversial points in the revenue act were resolved in favor of the revenue, that the rates of personal tax could be reduced 25 percent. (If certain administrative features were also added the figure would be substantially higher.)

These special tax concessions have economic effects, good and bad, but it is doubtful if any, or at any rate many of them, are more important in terms of economic stimulation than the possible reduction of rates which is their alternative.

The second point is that economists generally take a dim view with regard to subsidies, and an especially dim view with regard to tax subsidies.

With regard to the first, they regard the economic system as something kile a series of funnels in a board; the economic system automatically keeps these funnels full. There are two valves at the bottom that regulate the process, namely, prices and profits.

Generally speaking, the automatic process is beneficial, and the departure from it in terms of tinkering with the valves should involve a special burden of proof. But tax subsidies are specially suspect because they are covert, mask under a false label, and ordinarily do not carry their proper burden of proof.

Now, it is rather difficult to define a tax subsidy. My friend Mr. Blum suggests that it is a special feature of the tax law which a great majority of disinterested people would think bad. Be this as it may, it is possible to recognize a few specific cases fairly easily and I would say that the outstanding example would be percentage depletion. I name it because while the income tax generally provides return of capital costs, when percentage depletion departs from costs in the measurement of this right, it is at sea without rudder or compass, and 27 percent or 17 percent or 35 percent appears equally plausible.

As to the public interest, it seems probable that even citizens of the oil-producing States have nothing to gain over time by favoring the development of their natural resources.

Tax concessions are frequently justified in terms of their economic effects but the balance sheet on this matter often shows a preponderance of liabilities. Take tax-exempt securities as an example. They developed largely for constitutional reasons and the economic effects are largely bad. They encourage those who are best able to take risks to invest in areas more properly reserved for widows and orphans, and secondly, they encourage municipalities to borrow. Now we should all be interested in the neglected field of metropolitan planning. But the public works which are financed by taxes are of no less public interest than those that are financed by borrowing, and artificial encouragement of borrowing at the local level makes no economic sense at all.

Or for another illustration, take the forgiveness of capital gains that pass through transfer at death. Whatever may be said of preferential treatment of capital gains, in general, it is very doubtful if anything can be said on economic ground for the elimination from the tax base of those that pass by inheritance. It is frequently urged in objection to parity treatment of capital gains, that they discourage security transfers that are useful, and that they tend to lock in good securities, thus aggravating a boom market. But the exemption of securities that pass through death tends to aggravate both of these difficulties.

I think that is all, Mr. Chairman, except to say in conclusion that it would seem to me that a condition precedent for the reduction of taxes at the present time is reexamination of some of these special provisions in the tax law. Such reexamination might also provide the means to make such reduction possible.

Mr. MILLS. Professor Groves, is it your desire that your short paper appear at this point?

Mr. GROVES. I would prefer that my remarks, if I may edit them, may appear in place of the statement.

Mr. MILLS. We thank each of you for your appearance this morning, and for the information you have given the subcommittee in the compendium.

As I have said at each of our sessions, the subcommittee is concerned primarily with the economic principles which should be reflected in tax policy for economic growth and stability.

In connection with the topic under discussion this morning, we are trying to determine, broadly speaking, which type of tax policy will be more conducive to economic growth and stability, namely, one which attempts to get particular results through highly specialized tax provision, or one which is aimed at broad goals and operates through broad changes in the revenue system.

I think this is the philosophic question which must be basic to our thinking about tax policy for the future.

I would like each of the panelists, if they will, to comment on this question: Would you please express your views as to which approach is preferable and why?

Mr. Paul?

Mr. PAUL. Mr. Chairman, I chose the broad approach of those two for the reasons which I have tried to particularize in my paper. I think in the first place too much particularization or articulation in the code tends to make it more complicated, and it tends to make it more difficult for the Internal Revenue Service to administer.

I think it is possible that it has produced a number of discriminations, the principal ones of which I have tried to indicate. A discrimination against earned income, a discrimination which affects adversely low-income taxpayers, but also a good many high-income taxpayers who are unable for various reasons, which I would be glad to indicate, to take advantage of the various techniques now available for reducing their taxes.

Basic again to my conclusion is the consideration that in the kind of income tax system we have, with 50 million returns filed a year, we depend a great deal on the good will of taxpayers. We do not audit the majority of returns. It is impossible to do so. We really depend upon the capacity of the American people to accept their tax burden and so depending it seems to me that we should have as uncomplicated a system as possible.

I recognize it is impossible to make the tax law so simple that he who runs may read.

Mr. MILLS. Mr. Paul, let's orient this discussion and question to the basic questions that are before this committee. Of course, members of the subcommittee at all times, I am sure, would be interested in the equity of any situation. We are cognizant of the political implications involved in tax policy. We are also cognizant of the technical matters that go into the framework of a tax structure, but we are concerned now in this committee with the broad principles of tax policy from the viewpoint of economic growth and stability, and I was couching my question, not on the basis of equity political or technical considerations, but how would each of these approaches affect economic growth and stability over the years.

Mr. PAUL. Well, if I understand your question, Mr. Chairman——

Mr. MILLS. Pardon me. Let me put it this way: For the sake of economic growth and stability, which avenue should we travel?

Mr. PAUL. Well, as between those two general courses, I would say we should travel what you might call the broad road, rather than the particular road, from the standpoint of economic stability.

Mr. MILLS. Why?

Mr. PAUL. Part of the picture there would seem to be that we should consider from the standpoint of economic growth and stability, the necessity of taking care of consumption, or buying power, as well as incentives to work and funds for capital formation.

Mr. MILLS. You can, of course, stimulate investment or consumption through these highly specialized tax provisions. We know we have done it in the past. You can, therefore, obtain economic growth and perhaps some degree of stability through the use of that avenue. We perhaps have not endeavored as much as we should in the past, may I suggest, the use of the other avenue.

We are thinking here in broad terms of the course that we should follow in the future. Why, in the future, should we follow the broad course, broad goals that operate through broad changes in the revenue system, instead of a highly specialized tax provision arrangement? Can we expect greater economic growth, can we expect greater stability in the long run?

Mr. PAUL. Well, I think we can.

The income tax, to my mind, is an instrumentality for promoting economic stability, and anything that operates to impair the effective-

ness of the income tax as an instrumentality for collecting revenue also impairs the utility value of the income tax as a measure to counteract depression, or counteract inflation also.

Mr. MILLS. Mr. Blum, would you comment on the series of questions to this point?

Mr. BLUM. Yes. I would like to divide up the question in two parts, that dealing with stability and that dealing with economic growth. I feel very strongly that our economic stability in the future will have to be achieved mainly by reliance on monetary policy. In this respect I would like to endorse heavily the paper which was contributed by Herbert Stein, but I would like to add that a healthy tax system, and particularly a healthy income tax system, is an important condition for a satisfactory monetary policy; that is, to operate a monetary policy which will achieve stability without other undesirable consequences calls for a tax system, particularly an income-tax system, which will buttress that policy.

We see in France, for example, that the tax system from time to time has broken down, and as a result it is much harder for the French Government to operate a satisfactory monetary policy. It is for this reason that I would like to stress that the morale of taxpayers in our society is an important ingredient of achieving economic stability through proper monetary policy.

My concern is that with the increasing growth of special provisions in the law, at some point we will have passed the danger line in the deterioration of taxpayer morale. The temptation to cheat and the need for turning to others for assistance at every point, will have an impact on the health of our tax system and therefore a direct bearing on the possibility of accomplishing our goal of stability through monetary policy.

Now directing myself to the problem of economic growth. My main point here is that we should not try to direct our growth into specific channels by way of provisions in the tax law which favor one activity over another. We simply do not have the kind of foresight which will enable us to do this satisfactorily.

Let me take the case of oil as an example. I hold nothing against the oil industry, but it is quite clear that our subsidies through the tax system to the oil industry are increasing the development of our oil resources. It is quite possible, as some of our scientists have said, that within a few years the uses of oil may change completely as a result of the development of atomic energy. We then might find ourselves in the position that government, through its tax policy, induced a huge investment in the oil industry, only to have a lot of this turn out to be surplus.

I am not predicting that this will be the case. I merely point this out as an illustration. If we attempt to pinpoint in our economy the areas that we think ought to be developed, we are likely to find that our guesses are wrong. I favor allowing wide latitude for the development of private enterprise in a free market and allowing the decisions of individuals in our society to govern the allocation of resources. A broadly based income tax with as few special provisions as possible is most compatible with the kind of economic growth most people desire, and the kind in which we will have the least wastage of investment.

Just one other matter in this connection. Let me point out, as Mr. Atkeson and Mr. Groves have indicated, that the more we complicate our tax structure by special provisions, the greater the amount of human resources that must be devoted to operation of the system; more time is wasted in tax planning, more advisers are needed, more activity on the part of government and administrators is called for, and so forth, all the way down the line. This is the kind of effort which hardly contributes to economic growth, but which, if channeled in other directions, might very well do so.

Mr. MILLS. Professor Blum, is it your thought that tax policy, if aimed at these broad goals, and operating through broad changes in the revenue system, would of necessity then be neutral in its effect upon various segments of our economy, and as a result, be most conducive to economic growth?

Mr. BLUM. I think so, sir, yes; economic growth in the sense that we develop assets which we are going to find are useful to us, rather than a development which might be outmoded or which will turn out to be unproductive.

Mr. MILLS. In other words, under such a tax policy, other elements than taxation will supply the impetus or stimulus, and taxation would not provide any competitive deterrent under that arrangement?

Mr. BLUM. That is right. It would be as neutral as possible as between various types of investment decisions.

Mr. MILLS. Professor Cary, will you comment, please, on our questions?

Mr. CARY. Mr. Chairman, in relation to your general question, it seems to me that you divided it into stability, on the one hand, and growth on the other. I would divide in turn the question of stability into two phases—economic stability and stability of the tax system.

Now, quite frankly, the papers that have been delivered today seem to me not to relate very definitely to economic stability. They really are related to stability of the tax system, and that is what, rightly or wrongly, we all seem to be discussing on this particular panel.

As to the stability of the tax system, my own comments were primarily related to this question of erosion of the tax system.

On the question of growth as distinguished from stability, all of us are for it. We are also perhaps at times for specific provisions which would stimulate growth, but the problem, at least as I see it, is that we now have an infinite series of special provisions which are only obliquely related to this whole question of growth. That is one of the things which seems to trouble me most.

Another point that troubles me is an assumption that the tax system has a philosophy. My own feeling is that we have just about reached the point, and it has been exacerbated by the 1954 act, where the tax system doesn't have a philosophy. It is altogether a series of provisions that look as if they are related one to the other, but if you examine them, you can say "There is the so-and-so provision represented by somebody's pressure." That is one of the things which has troubled me. I don't say there was a philosophy before the 1954 act and there is no philosophy now. I just say the whole tendency by reason of this erosion, to which I have referred, has been toward eliminating any philosophy or pattern.

Mr. MILLS. I think you misunderstood me. I don't attribute any philosophy to the 1954 code, 1939 code, or any other code. I raise what

I think is a philosophic question, on which we must base any conclusions as to what broad tax policy we should have in the future for economic growth and stability. In the course of our examination of this subject matter, Professor Cary, permit me to call your attention to the fact that we are not at this time concerned with the problem as a subcommittee of stability of tax yield. We are concerned with the question of economic stability, and in that connection let me ask you if some of these preferential provisions in existing law do not have a destabilizing effect from an economic point of view.

For example, is the fact that we tax only 50 percent of a long-term capital gain, from the viewpoint of economic stability, stabilizing or destabilizing?

Mr. CARY. The problems of economic stability are beyond the range of the thinking I have done in this field at the present time, and I won't even attempt to arrive at an answer.

Mr. MILLS. Mr. Atkeson, will you comment upon our questions to this point?

Mr. ATKESON. Mr. Chairman, the question which you asked carries the implication, to my mind, that we know more than I would admit that we know as to the effectiveness of any of these particular devices that might be used to accomplish a certain purpose, both from the standpoint of their effectiveness by way of responsiveness of the taxpayer, and by way of the related portions of the economy.

For example, I think we could all agree that from the standpoint of economic growth, there will be considerable stimulant added by the accelerated depreciation provisions. I don't think anybody would argue that there isn't some immediate or temporary stimulant there. However, that does raise a question, when that stimulant has run its course, which well could be, does it not raise other problems in its wake that might be less favorable economically, and when will it be and how will the economy react? As a matter of fact, how do we know today—at least I don't know, perhaps others do—but how do we know today the extent of the use of the accelerated provisions? I am not criticizing them, nor speaking in favor of them. I am merely trying to point to something specific. Do we know enough about any of these provisions today from the standpoint of their effectiveness and the response of the community and the economy to them to go out on a limb, as far as we apparently have gone in connection with specialized treatment of special situations in a tax law, until the general knowledge is much superior to that which is commonly possessed today?

Now, you may ask me, how do we ever make progress if we don't try, and I would be the first to admit that if we knew any of these special provisions would work and would stimulate growth and increase stability, then, of course, I would say yes, use the tax law for that purpose. So as to the two questions, I would answer, to the extent that we know the tax law can be used to maintain stability or stimulate growth, I would use it for that purpose. I would say, yes, we ought to do that. To the extent we don't know, I think that the welfare of the country requires a more conservative, broad approach, and at this particular moment, I am not too clear as to the effect of these special provisions from the standpoint of their effectiveness to recommend that we continue to go down that road until we stand back and appraise the probable effectiveness of each new proposed special provision a little bit more.

Mr. MILLS. Mr. Atkeson, in my own view, I have never been as concerned over the desire deliberately to stimulate through use of taxes for economic growth as I have been concerned over the fear that through taxation we deter economic growth to some extent, and I find myself more in line with the thought expressed by Professor Blum, that we want a tax policy for the future along broad lines that may exercise a neutral effect upon various segments of our economy, so as not to deter those segments from growth when stimuli other than taxation alone justifies that growth.

Now, in the light of that desire, should tax policy then proceed along the broader avenue and not follow the more narrow application of these highly specialized provisions?

Mr. ATKESON. Assuming that all segments of the economy are in balance today, which assumption, is not particularly valid, then I would say that your neutrality approach is the correct one.

If you knew of some device by way of tax law to help bring about equalization between segments of the economy which might be out of balance today, and you knew it would work, I would see no objection to using that approach. But going back to my original statement, I am not sufficiently confident myself as to the effectiveness of any special provision under our complex economic system, so if I were in your position, I would take the safer course, the more conservative course, and say that from here on out, we are going to take the broad approach, until some particular situation arises where you need a special provision in the law to accomplish a certain particular end.

Certainly, your special amortization situation during war time was a special-type provision to stimulate the production of plants to provide wartime goods and services. I don't think that a specialized provision of that type would necessarily conflict with your basic long time policy of approaching it broadly, and on that basis I would subscribe 100 percent to the long-time broad approach.

Mr. MILLS. And the use of some specialized provision as a temporary device.

Mr. ATKESON. Right.

Mr. MILLS. But not as a permanent adjunct of tax law?

Mr. ATKESON. No, sir, only as temporary and only where there was substantial unanimity of opinion that you are exactly right, which we don't have today.

Mr. BLUM. Mr. Chairman, may we feel free to cut in?

Mr. MILLS. It is perfectly all right to cut in but I would like for Professor Groves to comment on the question, and then you may comment.

Professor Groves?

Mr. GROVES. Mr. Chairman, there are three elements that have been mentioned here, equity, economic growth, and stability. Equity obviously requires the even-handed application of the tax laws. Exceptions are sometimes made to that, for various reasons, of which economic growth and stability are among the most important.

Occasionally the three will all agree. There you have a specially strong case for action. Sometimes they do conflict. Then you have to compromise.

Always, I think you have to keep in mind that a special provision is at the expense of the general level of rates, and that a reduction in

the general level of rates, or prevention of their going higher also has good economic effects.

An example of a couple of provisions in the tax law which are opposed to equity, but favorable to economic growth, I suppose, are the special rate concessions to capital gains, and the differential treatment of undistributed profits in our present tax system.

On the other hand, I would agree with the chairman that the special provisions regarding capital gains are not conducive to stability.

The stability interest is mainly a matter of two elements: one is the progressiveness of the tax system, which affects its built-in flexibility, and tends to result in more revenue during good times and less revenue during bad times. Examples, that is negative examples, are the capital-gains provisions and splitting, both of which weaken the progressiveness of the tax and tend to reduce its built-in flexibility.

There you get a conflict between the economic stimulation considerations and stability.

The other element is timing, and again it as often as not happens that measures in conflict with equality are also opposed to good timing.

For instance, the LIFO provisions in our inventory tax accounting run counter to stability timing in that they reduce revenues in good times, and augment revenues in bad times.

Generally one is on sound ground to promote as much neutrality in the tax laws as possible. This is another way of saying that tax subsidies should be avoided. I note that nobody has favored exemption from the Federal income tax as a way of relieving farmers. Perhaps they are as entitled to an income-tax concession as some others that are favored.

But in general I take it this is an example of the proposition that we avoid subsidies when we can and we particularly avoid tax subsidies.

Mr. MILLS. Professor Blum, do you have further comment?

Mr. BLUM. Yes, Mr. Chairman.

First, your question to Mr. Cary was in terms of the impact of various special provisions in the tax law on economic stability today. I would like to offer the position that, notwithstanding Mr. Grooves' remarks on capital gains, I don't think any of the special provisions in the law has much of an impact on economic stability today, and I doubt whether the entire group of special provisions in the law taken together has much of an impact on economic stability. I think that a satisfactory monetary policy could easily be operated within this framework. I again want to urge that the danger to the health of the tax system, or to the stability of the tax system, from special provisions is itself likely to have serious implications for managing our monetary system in such a way as to provide us with economic stability. This danger more than outweighs any conceivable contribution to economic stability from these special provisions.

To put that another way around, I think if we put all the special provisions together on one side, whatever gain to economic stability there is from them (and I don't think there is much) or any loss to stability (and I don't think that is much) would not be an important consideration alongside of the potential danger to the system itself, through collapse or lack of taxpayer compliance, and so forth.

Second, on the matter of growth, accelerated depreciation has been mentioned several times, and almost always in terms assuming that it undoubtedly does contribute to growth. Here I want to join forces with Mr. Atkeson to point out that this is again a case of not knowing for sure what we are getting ourselves into.

The accelerated depreciation provisions today produce a differential kind of growth. They induce growth of a particular kind, as against other forms of economic growth which are possible. At this moment, it might look to us as though the type of growth being promoted is desirable, but 10 or 20 years from now we might find we went too far in this direction.

Let me also point out that we are already beginning to hear pleas from various portions of industry for even more rapid accelerated depreciation in particular areas, such as in some parts of the machine-tool area.

Finally, I want to note agreement with Atkeson that one of the difficulties with planned stimulation is that whenever we try to stimulate something through the tax system we are at the same time penalizing other activities. In passing, I would just like to mention three suggestions that I have heard during the past month for new special provisions. These were all made seriously, and some day they no doubt will be introduced in Congress. One is that in order to promote better foreign relations today we should allow persons a deduction for their expenses of foreign travel. I don't need to tell you who might be promoting this—it is pretty obvious.

A second is that we could cure our farm surplus problem today by allowing taxpayers a deduction for the purchase of agricultural goods that are in surplus supply—butter, wheat, corn, and so forth. Somebody else mentioned to me at the meeting in which this suggestion was made that we also solve the traffic problem in our cities by giving everybody who didn't own a car a special hundred-dollar income-tax credit.

And then, third, it was suggested that since we allow a deduction of burial costs against the estate tax we ought to allow burial costs to be deducted against the income tax. I don't suppose this would induce people to die but it might lead to the suggestion that someday we allow a deduction for marriage costs. That might promote economic growth.

Mr. MILLS. Professor Groves?

Mr. GROVES. If I may add a word, I would disagree with the remark about the relation of the stability of tax system to the stability of the economic system. I think the stability of the economic system requires instability in the tax system. That is, instability of yield at least——

Mr. BLUM. I agree with that.

Mr. GROVES. And at the national level. Secondly, with regard to my former remark about capital gains I did not say that capital gains contributed to the stability of the system. Special provisions with regard to capital gains probably do contribute to economic growth, insofar as incentives are important in that area. Thirdly, with regard to accelerated depreciation, my own view on that is that here you get a very good example of what is and what is not a tax subsidy.

I would say that a 5-year provision for accelerated depreciation is

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definitely a tax subsidy. It was designed to stimulate the production of military goods during an emergency. But the depreciation concessions of the 1954 act can be viewed quite differently. The strongest grounds for allowing business to deduct two thirds of the value of assets during the first half of their life is that those assets in reality, in fact, do decrease in value to the extent of two thirds during the first half.

Now, the evidence on the subject is not altogether clear, but if accelerated depreciation is an economic fact, it seems to me that this takes the depreciation provisions of the last law out of the area of tax subsidy, leaving the 5-year amortization in that area. Here you get a good example of the distinction between an unneutral and special favor on the one hand, and on that is in accordance with the economic facts on the other. Realistic depreciation allowances do not infringe upon tax equity; they contribute to it. As between two corporations, one with a lot of capital and one with very little capital, their incomes will not be properly compared relatively unless the actual depreciation is allowed as a deduction.

Mr. Mills. Professor Groves, I noticed in your paper on pages 288–289 you point out that uneven taxes may have an adverse effect upon the allocation of resources. That is what you are saying, in effect, now. By uneven taxes, I take it you refer to special provisions of the tax law which are not applicable to all taxpayers and which confer either special benefits or special deterrents on certain forms of economic activity.

In the case of many of the special provisions I can think of, the argument was advanced in their favor that they were necessary to remove discriminations or deterrents to certain desirable kind of activity.

Now, it occurs to me that we are interested, and should be interested, in balanced economic growth, and that when we provide special tax treatment for one industry, we are saying in effect that we want it to grow more easily and faster than others.

I wonder if we should make that kind of decision in tax law?

Mr. Groves. I think, Mr. Chairman, it is a very good statement and one that I could subscribe to wholeheartedly. I return to my funnels and board; the economic system automatically, through prices and profits, keeps those funnels full.

Mr. Mills. Is there any conflict with the statement or with Professor Groves' answer?

Mr. Groves. I would like to add one more sentence if you please, and that is that if you have a particularly risky industry, as it is alleged the oil industry is, then, of course, prices will be high and profits will be high in order to attract capital into that industry, and that all takes place automatically, without benefit of the tax laws. Of course, this is one reason why many of us are opposed to the theory of an excess-profits tax during peacetime; that the excess-profits tax tends to interfere with the automatic application of the profit valve on those funnels.

Mr. Mills. I think all of us would agree with you that so far as economic growth and stability is concerned, excess-profits tax has no place in peacetime, wouldn't we?

Mr. Paul, many of the panelists who have appeared here stress the need for a high degree of built-in flexibility in our tax system if we are to meet our objective of economic stability.

I believe there is a wide area of agreement that this built-in flexibility depends, in part at least, on the progression in the tax system.

In your paper you point out that the supposedly most progressive part of our tax structure, the individual income tax, is not very progressive. Can you elaborate more on the data you mention to sustain this conclusion?

Mr. PAUL. I tried to show that it is not as progressive as it is sometimes said to be by people who complain about the high rates, and perhaps not as progressive as it is generally thought to be by the public.

I would like to elaborate. I have just stated general conclusions in my paper or my summary.

Since I prepared those documents, I have taken the pains to prepare, on the basis of statistics of income, tables which go to the very point of your question.

The first table shows the effective rates of tax paid by taxpayers with adjusted gross income of a hundred thousand dollars or more. It shows those effective rates for the years 1946 through the year 1952, the last year for which data is available.

It shows that the effective rate for all taxpayers having incomes of $100,000 or more is from about 48 percent to about 56 percent of income.

Adjusted gross income is a concept which does not include half of capital gains, so that in my second table, I have reduced that table to a percentage of effective rate applicable to adjusted gross income, plus the other half for capital gains not included in adjusted gross income.

I have the table in those years only for 1950 and 1951.

Mr. MILLS. I think it would be very good for the record if we could include a copy of those tables at this point.

Mr. PAUL. I have 2 or 3 copies. I would be very glad to pass them up to the subcommittee.

(The table is as follows:)

Effective rates of tax paid by taxpayers with adjusted gross income of $100,000 or more

[Dollar amounts in millions]

Year	Reported adjusted gross income [1] (1)	Reported tax liability [2] (2)	Effective rate of tax (col. 2÷col. 1) (3)
			Percent
1946	2,066	1,168	56.5
1947	2,104	1,208	57.4
1948	3,057	1,509	49.4
1949	2,655	1,288	48.5
1950	4,057	2,045	50.4
1951	3,923	2,082	53.1
1952	3,324	1,776	53.4

[1] Income before deductions and exemptions. Includes only half of long-term capital gains; excludes such items as tax-exempt interest, percentage depletion, etc.
[2] Includes normal tax, surtax, and alternative tax.

Source: Internal Revenue Service, Treasury Department, Statistics of Income, pt. 1, 1946–52. 1951, p. 25.

Comparison of the effective rate of tax paid by taxpayers with adjusted gross income of $100,000 or more on basis of (a) adjusted gross income as reported, and (b) adjusted gross income plus excluded long-term capital gains

[Dollar amounts in millions]

Year	Reported adjusted gross income	Add: Excluded long-term capital gains	Equals: Adjusted gross income including 100 percent of long-term capital gains	Reported tax liability		
				Amount	Percent of—	
					Reported adjusted gross income (col. 4÷col. 1)	Adjusted gross income including 100 percent of long-term capital gains (col. 4÷col. 3)
	(1)	(2)	(3)	(4)	(5)	(6)
					Percent	*Percent*
1950	4,057	757	4,814	2,045	50.4	42.5
1951	3,923	705	4,628	2,082	53.1	45.0

Source: Internal Revenue Service, Treasury Department, Statistics of Income, pt. 1, 1950-51.; 1951, p. 77

Mr. PAUL. I made one further inquiry quite recently which goes very much to the point of the chairman's question. I became curious as to how progressive the tax is on incomes from a hundred thousand on up to the top. I therefore prepared a table which shows the total reported adjusted gross income for the brackets beginning with $100,000 and going up to $5 million, the reported tax liability on the basis of that adjusted gross income, the effective tax rate—that is, the actual effective tax rate, and then I have a column which takes 10 percent of the adjusted gross income which is a general adjustment to get adjusted gross income to taxable income, then I added back the excluded half of capital gains and I find that the effective tax rate on all income, including all capital gains, begins at about 43 percent in the bracket from $100,000 to $150,000 income; it rises to 50 percent for incomes between $1 and $1½ million, with the exception of the bracket from $4 million to $5 million, which I presume doesn't contain too many taxpayers, the rate is about 68 percent, but otherwise the rate ranges down around 50 percent or less.

Curiously enough, the table shows that the taxpayers having income between $1 million and $1½ million—$1½ and $2 million, have an effective rate of only 37 percent.

Those statistics are all taken from Statistics of Income prepared by the Treasury Department.

(The table is as follows:)

Classes (thousands of dollars)	Reported adjusted gross income (p. 25)	Reported tax liability (p. 25)	Effective tax rate, actual	Effective tax rate (allowing for 10 percent deductions) per 1951 rates	Excluded capital gain income (p. 77)	Effective tax rate, including all capital gains
	Millions	*Millions*	*Percent*	*Percent*	*Millions*	*Percent*
$100 to $150	$1,441	$688	48	59	$157	43
$150 to $200	687	356	52	66	98	45
$200 to $250	386	208	54	70	74	45
$250 to $300	260	145	56	72	51	46
$300 to $400	284	161	57	74	73	45
$400 to $500	170	99	58	76	46	46
$500 to $750	234	141	60	77	65	47
$750 to $1,000	116	70	60	79	36	49
$1,000 to $1,500	93	58	62	79	24	50
$1,500 to $2,000	78	44	56	87.2	42	37
$2,000 to $3,000	69	46	67	87.2	13	56
$3,000 to $4,000	39	25	64	87.2	17	45
$4,000 to $5,000	22	15	68	87.2		68
$5,000 or more	44	26	59	87.2	10	48
Total	3,923	2,082	53		706	45

Source: From Statistics of Income for 1951.

Mr. PAUL. So that I think the general conclusion, if I may add this, Mr. Chairman, is that we do not have a very progressive tax system at the top, or at least not as progressive a tax system as I myself had thought we had until I prepared this data.

From the standpoint of I think your early question, the less progression you have in the system, the less built-in flexibility you have from the standpoint of economic stabilization.

Mr. MILLS. Is it true also that built-in flexibility depends to a large extent on whether the tax base is responsive to changes in levels of economic activity?

Mr. PAUL. Yes. I think it is.

Mr. MILLS. What recommendations do you have for increasing this responsiveness of the tax base to the level of activity of the economy?

Mr. PAUL. Well, from the standpoint of increasing built-in flexibility in income tax, I think it would be a wise thing if we could increase the progression in the system, so that when we had a slump of some sort, we would automatically get less revenue, without a change in the tax law at all.

That isn't to say we might not want to make a change at a timely moment but there is virtue in automatic flexibility, because it responds immediately to an increase or decrease in the economic cycle.

Mr. MILLS. Do you think on the whole we might increase built-in flexibility by broadening the tax base to include more of the types of income sensitive to changes in economic activity, while at the same time lowering the rates?

Mr. PAUL. I don't think there is too much chance at the moment for lowering rates, except the top rates and the lowest income-tax rate. Perhaps I didn't understand your question.

Mr. MILLS. I am not talking about it at the moment, but if we have greater built-in flexibility as a result of making more of the total income which is sensitive to changes in economic activity subject

to taxation, then we could accomplish a material reduction in tax rates over a period of years, could we not?

Mr. PAUL. If we increase the base, of course.

Mr. MILLS. I am not talking about the base at the moment. I am talking about up and down the line.

Mr. PAUL. The total base.

Mr. MILLS. Total base.

Mr. PAUL. Total income subject to tax, if we increase that, broaden the base, we have more of a chance to decrease taxes because we have more income subject, generally to tax and in addition we have a more sensitive income-tax structure, because the broader the base, the greater then will be the effect one way or the other of a change in the economic trend.

Mr. MILLS. Mr. Paul, this final question and I will conclude: I have always been interested in the difference between personal income reflected each year by the statistics prepared by the Department of Commerce, and the personal income which is reported through the Treasury Department, Bureau of Internal Revenue, for tax purposes. I think I have observed on occasion that only 40 percent of the personal income reported by the Department of Commerce would be reported for income-tax purposes.

I don't remember whether that is the correct figure or not. Mr. Atkeson is shaking his head. Do you remember?

Mr. ATKESON. It varies among classes. You have about 95 percent of your salaries and about 79 percent of the dividend.

Mr. MILLS. I am talking about personal income reported by the Department of Commerce in its statistics and total personal income reported by taxpayers to the Internal Revenue Bureau. Now, if only 40 percent is reported for tax purposes, that would mean 60 percent of the total, which may well include items highly sensitive to economic activity, is not subject to tax effects, and therefore, the built-in flexibility of the tax system would not be very great if that much is excluded from it.

Mr. ATKESON. Just for the record, Mr. Chairman, the national income as I remember it is running somewhere around 310 billion.

The adjusted gross income on tax returns in 1952 was 203 billion, so it would be about two-thirds as of that particular year.

Mr. MILLS. Your taxable income though is much smaller than your adjusted income, and what would your taxable income figure be compared to the total 310 billion?

Mr. ATKESON. Generally, it would be about 10 percent less than the adjusted gross, excluding the deduction for exemptions.

Mr. MILLS. Only 10 percent less?

Mr. ATKESON. Somewhere around that neighborhood.

Mr. MILLS. Isn't it estimated for this year to be about 125 billion?

Mr. ATKESON. I haven't seen the estimate for this year.

Mr. MILLS. That is the figures I have seen.

Mr. PAUL. Mr. Chairman, I give some figures on page 303 pertaining to this point.

Mr. MILLS. My whole concern, Mr. Paul, as you can see, is that if only that small percent of overall personal income is subject to taxation, how can you have built-in flexibility in your tax system to the extent that you desire to have it?

Mr. Paul. I think the figure, if I am not incorrect in my analysis of it is somewhat higher. I see I have a statement, on the average, 86 percent of consumer money income after excluding military income, social-security benefits, and unemployment compensation, pensions, and annuities is reported, so that is a rather higher percentage.

Now, the percentage varies from class to class, but we do get 86 percent after we make adjustments for the different concepts of the Commerce Department.

Mr. Mills. Dr. Atkeson reported personal income which includes all of these things which you excluded, I think.

Mr. Groves. Mr. Chairman, maybe I can straighten this out. There are 2 or 3 different things here. There is a leakage in adjusted gross income, there is income not taxed, and there is personal exemptions; but what you are talking about is the tax base.

Mr. Mills. That is right.

Mr. Groves. The tax base can be computed very easily. It is about 4 times the tax. That is, the effective tax rate is somewhere in the neighborhood of 25 percent; so take 32 billion and multiply it by 4 and you get very close to the tax base which is in the area of 125 to 135 billion, which in terms of the national income would be well below half.

Mr. Mills. Near 40 percent. Then my question arises, Can we have the desired built-in flexibility in our tax structure with most of the total personal income not being reflected in the tax system?

Mr. Groves. I would answer that some of those exclusions probably support built-in flexibility. I judge that the $600 per capita exemption on the whole does.

Mr. Mills. I am not suggesting, Professor Groves, that all personal income be reflected in the tax structure, but I am concerned with the question of how you can have the desired degree of built-in flexibility with more than 50 percent of your personal income not reflected in your tax take.

Mr. Groves. I would say that the ways to increase built-in flexibility of the tax system are mainly 3 in number. First, to rely heavily on the income tax as compared with other taxes; second, to maintain the progressivity of the tax. (Nearly all of the things we have been talking about reduce progressivity of tax; this is true of splitting, captial gains concessions, tax exempt securities, and the dividend credit.) Thirdly, I think the built-in flexibility of the system is supported by aids to the States, because the tax system includes State and local taxes as well as Federal taxes, and State taxes on the whole are regressive as compared to the Federal tax.

It is also true that a great deal depends upon progressivity at the bottom of the scale, as well as at the top and in that range, splitting is particularly important to built-in flexibility.

Mr. Blum. Mr. Chairman, first, I would like to clear up a terminological difficulty. I have been using the phrase "stability of the tax system" not as referring to stability of the revenues, but as referring to the tax system itself—that is, the willingness of taxpayers to comply, and so on.

Speaking for myself and I am sure for Mr. Cary, we would agree that instability of revenue is a desirable element in stabilizing our economic system.

I would also like to point out that, as I believe Mr. Groves began to say, as far as instability of revenue is concerned, the most important thing is not that the income tax is progressive, but that income is being taxed.

That is, the very fact we have an income tax is mathematically and quantatively more significant for instability of the revenue than the fact that the income tax system is progressive.

Progression adds to the instability, that is true. But the main change in total revenue comes about because, as the economy dips, total income is reduced and, therefore, the total income tax take is reduced.

Progressivity contributes to this built-in flexibility. In this connection, it is the progressivity at income level where the bulk of the taxpayers are and where the bulk of the income is, which is much more important than the dramatic progressivity found in the tax rates at the top. The take from millionaires or from those with incomes of $100,000 and above is not much of the total tax take and thus can't have much impact on the total revenue from the income tax system.

Mr. PAUL. I agree with that.

Mr. MILLS. Do all of you agree with Professor Blum's statement?

Senator Goldwater will inquire.

Senator GOLDWATER. Mr. Cary, I am very interested in your paper which you presented this morning, also your overall paper, dealing with the increasing erosion of the revenue laws, and to the increasing erosion of revenue.

In your first sentence this morning you said, "pressure groups appear to be active and effective in a constant erosion of our tax system."

You did not, however, indicate in your paper whether or not you would include co-ops in your statement.

Do you include cooperatives in your thinking of groups that are effecting pressure and also contributing to erosion in revenue?

Mr. CARY. I don't have any final opinion with respect to the taxation of cooperatives, but I have no doubt, and I am reasonably certain, in fact they are exerting some pressures.

I have no doubt that each segment, which either is affected by legislation or has not yet been affected, is in one way or another a pressure group. I suppose that everybody in our society is in one way or another a pressure group.

Some are more effective than others.

On the general question of whether or not a cooperative should be exempt, I have no opinion.

Senator GOLDWATER. Would you have an opinoin, then, on a statement made by Mr. Schmidt, in his paper on page 235, at the bottom of the page, and also the top of the page, 236, and I will read it:

> Successive administrations in Washington and congressional committees have wrestled with the problem of taxation of cooperative enterprises. It is generally agreed that the cooperatives are a legitimate form of doing business, but it escapes certain taxes which are levied on the corporate form of doing business. If the disparity between the tax burden on the cooperatives and corporations is not corrected, we will drive more and more businesses into the cooperative form.

I had to read that because of your concern in erosion, and ask if you agree with Mr. Schmidt's statement, that this might not be a very dangerous—or I will put it this way: Potentially dangerous form of erosion of our sources of tax revenues.

Mr. CARY. Senator Goldwater, I don't know the statistics on the amount of revenue that is alleged to be lost by reason of the existence of the cooperative exemption. That is one consideration, of course. Then the next question I would have to ask is whether we favor cooperatives, and, indeed, whether we feel that it would be a tragedy if, as Mr. Schmidt has said, we should drive more and more businesses into the cooperative form.

On the practical question, I don't know whether it will drive them into a cooperative form. Regarding many companies which are normally operating as private corporations, I would raise some question, although, frankly, I do not know one way or another. I haven't even arrived at an opinion as to the extent that that would be a danger. I am quite willing to recognize with you that there is undoubtedly pressure exerted by cooperatives. I, nevertheless, cannot take a position, because I haven't formed an opinion with respect to the general cooperative problem, as has Mr. Schmidt.

Senator GOLDWATER. My concern is not particularly with the pressure, because, as you suggest, all groups do have that. I mentioned your first sentence only to lead into this subject, because I feel personally that there is some reason to be fearful that many American businesses might take up the cooperative form, if tax disparity or tax preferential treatment continues, and I don't look on it as a problem that is dangerous at the moment particularly, although some would disagree with that direct statement. I look on it as a future danger.

Do any of you other gentlemen have any thoughts on that?

Mr. GROVES. Mr. Chairman, with regard to pressure groups and cooperatives, I take it, first of all, that everybody concedes the right of organized groups to present their point of view on legislation; that the weakness in our political system is largely associated with hearings, whereby a concentrated interest can afford the time and the money to be well represented, whereas a widely dispersed interest finds it much more difficult to appear at hearings. One of the persuasive justifications for occasions such as the joint committee's hearings is that they seek balance in the presentation of evidence.

With regard to the taxation of cooperatives specifically, I would make three observations: First—and I hope this isn't in conflict with what I said before—nearly all cooperatives at the present time are rural. They are very largely farm business. This is worth noting.

Second, the main issue with regard to cooperatives is in the treatment of patronage dividends, which have been troublesome for the income tax all over the world, but in almost all countries are exempt, on the ground that this is a case of giveaway—a "retroactive price cut"—for the corporation itself.

These dividends are taxable to the individual, if they are incident to production, as contrasted with buying groceries or something of that kind; they are taxable to the individual, and I would suggest that one of the first remedies in this area is to do a much better job of administration at the personal level. The most you can say is that this income is not subject to a double tax, where some other income is. Co-op dividends are taxable, but we know that at the present time, without the application of withholding to dividends, that it is impossible to administer the income tax for driblet income in interest and dividend. I would suggest that a first remedy consist of a much

improved administration of the income tax on the whole flow of dividends.

Senator GOLDWATER. Would that suggestion indicate the thought that withholding should be done at the source?

Mr. GROVES. Yes; that is the idea.

Senator GOLDWATER. Mr. Blum?

Mr. BLUM. Mr. Goldwater, I merely want to add one comment to Mr. Groves, remarks about patronage dividends and the dividend problem generally in the case of cooperatives. He mentioned that a dividend is really a form of price reduction to the consumers who patronize the co-op, and, therefore, perhaps income of the co-op ought to be regarded as something different from the income of a corporation. This requires distinguishing between that form of income of the co-op which really goes back to the customer of the co-op as a price rebate, based upon a percentage of his purchases, and those forms which go out in another fashion, and which only in an unrealistic sense could be regarded as being a price rebate. I take it that Mr. Groves' remarks were addressed only to the form of patronage dividend which could truly and realistically be called a price reduction for the customer.

Mr. GROVES. A cooperative is always open to the alternative of cutting prices directly, and I suppose an attempt to tax patronage dividend would force the cooperatives into this device, which is largely used among the Swedish cooperatives, for instance. Whether there would be a social gain in that forcing process is a question that involves a great many aspects.

Mr. BLUM. My comment, Mr. Groves, was more specifically this: You were not suggesting that we treat as price rebates the co-op dividends which do not go to customers, based upon the amount of spending they have done with the co-op during the year.

Mr. GROVES. No; not at all. There are some abuses that can be associated with the cooperatives which I think even the cooperatives themselves would suggest are worthy of the attention of the revenue system.

Senator GOLDWATER. I am glad to hear this discussion.

I want it made perfectly clear that my concern is not with the rural or farm cooperative, which is generally, I think, universally recognized as proper—having produced some good and valuable results. My concern and reason for asking the original question was because you gentlemen are interested in decreasing erosion of the revenue laws. In fact, I think it is a very important part of this discussion. There are many businesses today in this country, operating under the cooperative provisions of the law, which are not rural in nature, but which are big-city in nature and have branched out into the oil business, the bank business, and it is perfectly possible today for any American business to organize under the cooperative laws.

I hope that in your future thinking on this subject you will devote some time to it, because unless we do think about these things before the danger really becomes a danger, it can blossom upon us quickly.

I ask and hope that each one of you will, in your thinking, give some thought to this. This is the first time we have brought this out in this hearing. I imagine it will come out in some of the other papers, as indicated in the book.

That is all I have.

Mr. MILLS. Senator Douglas will inquire.

Senator DOUGLAS. First, may I both thank the members of the panel and congratulate them. One of the great difficulties Congress has in determining legislation is what Mr. Groves has referred to; namely, that the diffused interest of the general public finds it very difficult for it to be represented before legislative bodies, because for any one person it is a great sacrifice to take the time and trouble and expense to testify. Only people like Louis Gilbert, who seems to take a great joy in combat, will do that, and so I want to thank you for making the sacrifices which I know you have made to prepare your testimony and to come here.

There are a series of rather specific, pinpointed questions I should like to ask and I would like to begin, if I may, with Mr. Paul.

I was struck, not only with the very correct point that the actual rates of progression in the income tax are far less than the nominal paper rates, but also with your statement that many in the higher income brackets either do not choose to take advantage of the special provisions, or are not able to come under them, and that as a result, there is discrimination against people in the same income bracket. I wonder if you would develop that point at greater length, and indicate what the various components of this group are.

Mr. PAUL. Well, Senator Douglas, first, as a specific example, I would mention the officers of corporations which do not have their stocks listed upon the exchange, or any readily available market value for the stock. The stock option provisions have an 85 percent clause; that is, the option price must not be too far away from the value at the time the option is given, or else the disparity may be taxed as ordinary income.

If the terms of the statute are met, then the officer who received the stock option may take advantage of the stock option provision.

Now this discriminates against the officers of many corporations, generally smaller corporations, which do not have their stock listed, where it is difficult to get a value, and it is therefore impossible for those high bracket, often quite highly paid officers, to take any advantage of that provision, and possibly other provisions.

Senator DOUGLAS. You mean, for instance, the officials of Ford would be at a disadvantage compared to General Motors?

Mr. PAUL. Ford is now about to list the stock.

Senator DOUGLAS. But prior to that time, they were.

Mr. PAUL. That is a strikingly dramatic example, but there are many coporations which do not have their stock listed, and therefore a highly paid official of those corporations is not able to avail himself of the stock option provision.

Now I hope I won't be thought to be pleading the cause of my own profession if I mention also that professional people, including doctors, accountants, lawyers, whose income consists of earned income, have very few methods available to them, and they generally are in this high bracket class if they are successful.

Senator DOUGLAS. What about business expense as an offsetting factor?

Mr. PAUL. I am talking about their net income. Some of these professional people make substantial net income after expense. Now it is true that there may be some abuse of the expense account deduction by this class, but my experience, it is a very minor factor in the equation.

Mr. BLUM. Especially in the case of lawyers.

Senator DOUGLAS. I would just enter a slight demurrer that your profession and allied professions have something of an escape clause in the expense allowances, but go on, please.

Mr. PAUL. Perhaps I am overlooking some of my opportunities, but I think it is generally true, Senator Douglas, speaking in terms of net income after expenses, after legitimate expenses, that this professional class—and another group which would be adversely affected by this discrimination, another high income group, would include the owners of individual businesses which have substantial profits, but which cannot, for instance, leave their profits in a corporation and take advantage of the lower rate, the lower corporate rate, because though it is 52 percent, the corporate rate is less than some of the higher marginal rates.

Senator DOUGLAS. Are those the only points that you wanted to mention? What about those who get rather steady income from securities which do not appreciate in value—market value?

Mr. PAUL. Well, if they get a large income from securities, it is hard to think of so many securities nowadays that haven't appreciated in value, and therefore made available capital gain income, but anybody who possesses securities which don't increase in value and has a substantial income from those securities might be in the same position, so to that extent I would say that there is discrimination against unearned income as well as earned income.

Senator DOUGLAS. There is a question I should like to raise on the capital-gains tax. As I understand it, the British do not have what is technically known as a capital-gains tax.

Mr. PAUL. That is correct; in a limited sense. They class a great many things as ordinary income.

Senator DOUGLAS. On that point, what about the items which we regard as capital gains, and hence taxable at a rate one-half that of the ordinary rate, subject to the 25 percent maximum, as compared with the items which in Great Britain would be treated as ordinary income?

Mr. PAUL. I can't answer your question in particular. I can generally that the British concept of what constitutes a capital gain is very much narrower than our concept. A great many of the items which we would call capital gains, the British would call ordinary income and would not receive exemptions.

Senator DOUGLAS. What would happen to the speculative profits, under the British tax, of a professional speculator?

Is anyone acquainted with that?

Mr. BLUM. That would be ordinary income. It would be outside the category of a profit from a casual transaction.

Senator DOUGLAS. And therefore taxable at the British income-tax rate which is much higher than in this country. Now in this country that is regarded as capital gains, is it not?

Mr. PAUL. Yes, it is.

Senator DOUGLAS. If the security is held for 6 months, that is?

Mr. PAUL. Provided the security is held 6 months, a person who has a casual gain from, say, stock or real estate, gets capital-gain treatment.

Mr. MILLS. If you will permit an interruption, I think it should be pointed out in the record that a dealer in securities has his income treated as ordinary income in this country for tax purposes.

Mr. PAUL. Yes.

Senator DOUGLAS. You mean the fees?

Mr. MILLS. No; the profits on his own investment. That is ordinary income, not a capital gain.

Mr. PAUL. A dealer in securities is treated just like a grocer; that is, his securities are just like the goods a grocer has to sell.

Senator DOUGLAS. But what if he is a speculator, though not a registered dealer?

Mr. PAUL. I don't think he has to be registered.

Mr. BLUM. He is permitted under our tax law to segregate his securities, separating those that he is holding as a dealer from those he trades in for his own account.

Mr. CURTIS. He has to follow certain specific regulations in setting up that account.

Mr. BLUM. That is right. Once he makes the segregation, he can't move securities from the dealer account to his investment account.

Incidentally, Senator Douglas, in the case of a man who is an active trader, but who does not deal in securities in the sense of holding them for sale to customers in the ordinary course of business, no matter how active he is in trading—he may make hundreds of transactions a month—he gets capital-gain treatment. That is unlike the British treatment; there the profits of a man actively in the business of trading where sales are more than casual sales, would be regarded as ordinary income.

Senator DOUGLAS. So that if we were to abolish the capital-gains tax, we would get a much larger proportionate increase in revenue even at the same rates of taxation than we get under the capital-gains tax.

Mr. BLUM. I don't know how the two magnitudes would compare.

Mr. PAUL. Of course, if we increased the rates too much, if we treated all capital gains as ordinary income, we would have the problem of whether anybody would ever sell securities.

Senator DOUGLAS. Have you given any thought to the length of time we should use in deciding whether or not——

Mr. PAUL. One of the theories of the capital-gain differential is that it is designed to prevent a bunching of income; that is, concentration in 1 year of income which has taken several years to accrue. From that standpoint, the 6 months' period doesn't make very much sense. When I was appearing before Congress, when I first appeared, the period was 18 months. That was before 1942. It has been reduced to 6 months since then, but the shortness of the period certainly makes mincemeat of that particular reason for the differential rate.

Senator DOUGLAS. When we had the 1951 tax bill before us, there was a very strong movement to include livestock, which I remember I opposed, and also turkeys.

Mr. CARY. Turkeys got in also but they were finally eliminated.

Senator DOUGLAS. I believe we closed the door to chickens but turkeys got in. I wonder whether you would say gains made in livestock raising and turkey raising are income or whether they are capital gains?

Mr. PAUL. In my book it is just ordinary income. A man is in the business of raising turkeys, and—or the same applies to livestock. I don't see any basic justification for the application of capital-gain concept to that kind of ordinary income.

Senator DOUGLAS. I wonder if there is any disagreement?

I felt that chickens were being unfairly discriminated against in view of the fact that their cousin, the turkey, was protected in this fashion. Although I disagree with protecting both of them I am not certain what is done in the case of geese. Do you know whether geese fall in the chicken classification?

Mr. PAUL. I think the turkey provision was finally eliminated, Senator.

Mr. MILLS. I was trying to get Senator Douglas's attention, to call that to the panel's attention.

Mr. PAUL. There is no discrimination against geese, chickens, or turkeys.

Senator DOUGLAS. You mean all fowl.

Mr. PAUL. It seems as if nobody has any complaint about treatment or discrimination among fowls.

Senator DOUGLAS. Fowls are excluded, but sheep, cattle, and hogs are included?

Mr. PAUL. They are included if they are for breeding and dairy purposes.

Mr. BLUM. Breeders and culls, I believe, are included.

Mr. PAUL. If I grow a steer merely to eat myself, I get no capital-gain treatment if I sell it. It is only stock for breeding and dairy purposes which receive preferential treatment.

Senator DOUGLAS. And the fattening industry is therefore excluded from capital gain?

Mr. PAUL. That is correct, sir.

Senator DOUGLAS. Mr. Cary?

Mr. CARY. Senator Douglas, I would like to make a couple of comments with respect to capital gains generally. I might say that Mr. Mills first raised a question with respect to it in relationship to economic stability, and on that point I have no opinion. However, I did want to make several other points. The first is one made by Mr. Paul a little while ago; namely, that one of the functions of capital gains is to protect against the bunching of income. I raise a question if that is one of the major reasons for capital gains, whether or not there is justification for capital gains in respect of corporations. Capital gains are not only a function of bunched income, but also of the progressive rate system; namely, if I am in an 80-percent bracket in one year, and say a 50 percent in another, it would be unfortunate if the income were bunched in the year in which I am in the 80-percent bracket.

Of course, with respect to corporations, there isn't essentially any progressive rate structure for practical purposes. And I therefore raised the suggestion that we might consider the elimination of capital gains with respect to corporations for that reason.

Other people may have views on that.

Mr. MILLS. May I interrupt?

Senator DOUGLAS. Of course.

Mr. MILLS. Is there another reason capital gains to a corporation might be eliminated; namely, that the assets used in trade or business

are generally depreciable? Would you include that in your thinking as one of the reasons or not?

Mr. CARY. Well, of course, the capital gains has been broadened in the corporate field by what is known as the 117–J provision. I don't know the new number——

Mr. MILLS. 1231.

Mr. CARY. Yes, 1231. I would say that that factor wouldn't change my view. I do raise in my own mind the elimination of capital gains with respect to corporations, even though I hesitate to go so far as to recommend the total elimination of capital gains. I am not sure enough in respect of certain types of situations to make such a suggestion.

Mr. MILLS. Do you consider 1231 a distorter of resources?

Mr. CARY. 1231, as I recall, was enacted in either the prewar period or just at the beginning of the war, and it may have had a useful function at that time. I have some question now whether it is a necessary and integral part of the tax system.

Mr. MILLS. Are you thinking in terms of 4-year Cadillacs?

Mr. CARY. Maybe.

Mr. MILLS. I am sorry. I didn't mean to take over.

Senator DOUGLAS. That's all right. You know a great deal about this field and it helps very much.

Mr. ATKESON. I want to comment on the last point he made about the corporations and capital gain, from the standpoint of bunching. I was going to suggest that if it were made a part of the carryback and carry-forward operating expenses of the business, rather than being separated from them, then, of course, the averaging effect could still be had in the case of the corporation, whether or not it had preferential treatment. I just mention that as I don't think he mentioned the fact that capital gains are not subject to the carryback provisions.

Mr. CARY. That is a very good addition.

Senator DOUGLAS. Well, now I should like to address my questions to this latter point; namely, the problem of averaging, in which I include carryback and carry-forward. The present provisions are to carry 2 years back and 5 years forward. There is a 7-year average, roughly, is there not?

Mr. BLUM. Eight.

Senator DOUGLAS. Including the tax year, eight.

Why should that not be made applicable to earnings of authors and musicians, actors and other similar occupations?

Mr. BLUM. This doesn't operate as an averaging system, Senator Douglas, unless there is a loss in at least 1 year; if in each year there is either zero income or some income, there can be no benefits from the loss carryover mechanism.

Incidentally, going back to Mr. Cary's suggestion, if one were to consider abolishing the corporate capital gains tax, attention should be paid to the carryover basis where property is contributed by a stockholder to a corporation. You might recall that in those circumstances if there is a nonrecognition of gain or loss the corporation picks up as its basis for the property the basis which the contributing stockholder had had. Suppose he buys property for $10,000 and it is worth now $100,000, and he contributes it to the corporation; and suppose the corporation turns around and sells that property soon after it received

it. The company would have a $90,000 gain, despite the fact the increase in value did not take place while the corporation owned the property. To tax that gain at the full corporate rate, I think, would be a serious injustice. So I suggested that under the Cary proposal one might have to reconsider this carryover basis provision.

Senator DOUGLAS. I would like to raise this query: Why could not the principle of averaging, say on an 8-year basis, be accomplished, both as to what is now regarded as capital gains to avoid bunching and also to types of income which are now taxed in the taxable year; namely, royalties of authors and musicians, income of actors. I don't know when a politician begins to deteriorate, or a lawyer, but——

What about this principle of averaging capital gains, and other types of noncontinuous income?

Mr. GROVES. I am quite sympathetic, Mr. Chairman, with the suggestion.

It seems to me that the averaging of income is generally recognized as a good idea theoretically, but very difficult to apply generally. Thus progress in this area is likely to come from an extension of the few provisions we have in the law for spreading income under specific circumstances, as in the case of a person who prepares a book over 36 months' period, or something of that sort. I would hope that those special provisions, at least, might be extended to include such areas as capital gains and losses. Then if you got the rates down by the elimination of some of these special provisions that we have talked about, you might be able to include capital gains for ordinary treatment. This combination of changes would eliminate a lot of litigation, lawyers' work if you please, and in addition would greatly improve the tax system.

Mr. PAUL. That suits me.

Mr. Chairman, just to get the complete picture on this capital gain taxation before the subcommittee, I always liked the provision for treatment of capital gains which was in the statute before we had the 1939 code.

It was in there about the middle thirties, and I think it is cited in my paper, and the principle was applied, that the differential rate in favor of capital gains was lower, the longer the period of holding.

The period of holding in the statute was totaled up to 10 years and no differentiation was made beyond that period.

I think it was in the 1936 act that we abandoned that system as too complicated. Perhaps with the increasing complication since 1936 we might not be so overcome by that difficulty now.

Senator DOUGLAS. Thank you, Mr. Chairman.

Mr. MILLS. Mr. Curtis will inquire.

Mr. CURTIS. Mr. Chairman, I wanted to go back to a basic observation that occurred in two of the papers, and I think runs through some of the others.

The effect of all of this on the morale of the taxpayer: I was a little disturbed, I might say, at the way in which the thinking went in at least two of the papers, because I think there are two ways of looking at the special provisions in tax laws.

One way, of course, is what I would regard as a cynical outlook, with everything done as a result of, without throwing in other adjec-

tives, "improper pressure groups," and that there is no other base behind it.

I make this observation: We have two basic kinds of special provisions in our tax laws.

One is the kind that might be called tailoring.

Any time we draw a line, as we have to draw lines, with words, we are going to have to let some things fall on one side and some fall on the other. Of course, the rulings of the Treasury Department, as well as the Bureau of Internal Revenue, are attempts to further define that line, and sometimes it comes back to the Congress to redefine that line, and a great deal of the special provisions are along the lines of codifying rulings drawing this line. Or clarification, where we did not use words that described a particular situation or, 3, to correct an inequity where the line, where we actually do change the location of the line. Where we did not include a particular occupation it seems we should have included.

I might say turkeys was a very good illustration, because the issue—and it is a serious one; incidentally, I voted against turkeys in the Ways and Means Committee, but there was good argument.

It was not a specious thing or really a funny thing. It was funny because of the fact it involved turkeys, I suppose, but the problem was this business of capital gain.

We had found in the livestock industry, where so much money was put into a prize bull. He was not used for meat, or anything other than breeding. He was kept. He, actually, due to the amount of money apparently that goes into those animals, at least they argued, was a capital investment, and the Congress concluded that that was a fair observation. It had not been clarified. The Treasury ruling had been otherwise.

Now, of course, the turkey people came in, and something I did not know, Senator Douglas, about a tom turkey, and this only was applying to the breeding stock.

The tom turkey apparently lives a pretty long time. That was the distinction, the differentiation they were making between turkeys and chickens, incidentally. I don't know if any other poultry has the male animal who does live a long time.

I simply thought that was—or the reason I emphasized it, I think it illustrates quite well what I am saying: that these matters which come before the Ways and Means Committee, and the Senate Finance Committee for Special Provisions can pretty well be broken down into these technicalities, where you are trying to draw a line.

There is no question there is pressure put on. Of course the turkey industry is interested in this particular thing, but I don't believe the use of these terms—and I regard them as epithets—"preferences," "loopholes," "special privileges," "largess," "favors," et cetera, is entirely fair if the specific issue is to be judged on its own bottom.

It is perfectly true that if the arguments and facts adduced in these cases where we are trying to bring about these definitions are incorrectly stated, that it may result in something that amounts to a favor, but I don't believe that it gives an accurate picture, to regard these attempts to tailor the laws to meet the actual situations in that light.

I would make this observation on the morale of the taxpayer: If the taxpayer did not have an opportunity of presenting the case where

70325—56——18

he thought there was an injustice, I suspect that we might have much more lowering of morale that way than if we just shut the book on this thing, and refused to take a new look at each one of these definitions.

I think the morale of the taxpayer depends on whether the tailoring that is done is good or bad, and if the Congress has been doing bad tailoring—and in some instances I could not agree with some of the panelists more that the tailoring has been bad in certain instances, in other instances I think the tailoring has been good but the test on the morale of the taxpayer seems to me to lie there, not the process of writing in these special provisions.

Now then the second observation, and I am going to get to the question, I really will—is in regard to the second aspect of special provisions, which are more or less I would term them, provisions to get specific economic results—"loopholes," if they want to be called that or another way to describe them is removing an obstruction from the free flow of the economy, depending on whether you are in favor of it.

If you are in favor of it, you are "removing an obstruction." If you happen to be against it, it would be a "loophole," but it points up something that Mr. Mills has observed and I have observed from all panelists, whether knowing we can effect economic results through our tax structure and although we may have originally started this tax structure for the purpose of having revenue, we have found this effect, then we deliberately go about trying to produce an economic effect by providing special privilege.

One of the best illustrations I know is the certificate of necessity.

That was very deliberate in an attempt to produce an economic effect, personal depletions is certainly another example.

This stock dividend credit was another attempt, although I think the purpose has been misrepresented.

Rather I want to put it this way: The purpose has not been portrayed to the public as to what it was.

Farm co-ops, which Senator Goldwater mentioned, just to list a few—giving babysitter costs to mothers is another example, and in almost all these instances of "loopholes" or "removing obstructions," debate or discussion in the Ways and Means Committee has been around this question of the economic results.

In my own mind I question whether it is good to use a tax power to produce these things. There is no question in the observation of the panel that as we do use them, we certainly are eroding our tax base, but the power of the taxing power depends on this high rate I might observe and every time we do let a little stream go out here or out there we lessen the retained power that we do have.

All these loopholes, or whatever they are, seems to me particularly in the light of the papers that were presented and the discussion here, on the real loopholes, the disagreement seems to be on the economic effect that has been caused, rather than employing the technique.

For instance, Mr. Cary and Mr. Paul in their papers, it was significant to me that there was no mention of this co-op problem or mutuals. In their listing of what they call loopholes because I suspect—I may be reading something into it—but it seemed to me that they probably thought that that was economicaly good, while these other things they thought economically were not good.

I would agree with them on a lot of them, but for the purpose of our discussion, what I wonder is how about the technique of using tax deductions to produce economic results?

Is that technique good? That is the question I want to come to.

Now I will start with Mr. Paul, because I was addressing some of my remarks to him.

Mr. PAUL. I do not want to be understood, Mr. Curtis, as being against the use of taxation for incentive reasons. Certainly during World War II and more recently when conditions seem to so require, we resorted to your example of amortization.

I participated in the first one of those moves from the administration standpoint.

We had to get production. We were in the war, I would be the last one to sit here and testify that there was never a time when we should grant some particular favor to some segment of the industry.

I think they should be generalized and not particularized, but we should upon occasion grant some favors to accomplish some economic results.

The trouble seems to me to be that we have overdone that process. We have at times granted favors to get results when they were not required, or inadvisable.

I have had the honor of being before the Ways and Means Committee a good many times and in executive session a good many times and I know how difficult these problems are when they are presented.

Mr. CURTIS. Let me ask you this on that one thing, and one other thing, too, is what goes in is a temporary thing for emergency, which is very apt to become permanent.

We have still got certificates of necessity in.

Incidentally I had a bill in last session to try to get them out.

Mr. PAUL. You are quite right, Mr. Curtis. Percentage depletion is the extreme example of that. That came in in World War I in the form of discovery depletion and it has been in ever since.

The emergency it seems to me has long ago expired.

In any event, I would like to urge upon the subcommittee the necessity of a very strong case being made every time such a provision is inserted in the statute, a very strong case in terms of the necessity, in terms of economic growth or stability for a particular provision.

That is perhaps where we have slipped, perhaps if I may use that term without criticism.

We have accepted too many of these arguments, and the result is that we now have this patchwork statute. Basically it seems to me we ought to let the economy take care of these things.

We ought not to favor, on a weak case, some particular measure, unless it is absolutely demonstrable that the economy really will benefit from such an incentive provision.

Mr. CURTIS. You would also add the belief would you not, that we ought to sort of review those that we have got in there?

Mr. PAUL. I tried to say that, although I realize that is rather a heroic approach.

Mr. CURTIS. I think Secretary Humphrey has that philosophy, that it is desirable.

It goes back almost to the philosophy of government. I should not try to quote what he thinks as a matter of fact, but to check my own position.

I have the inclination, and more probably more strong than yours, to want to get away from even trying to effect economic effects of the tax power, but rather to get back to our revenue principles, and somewhat along the lines that Mr. Mills said.

We know that any time we try to tax we do have some kind of economic effect. We know what that is going to be, because we have to get the money.

But I question whether we ever deliberately—whether we should ever deliberately use that power to produce these things, because it seems to me it is such an easy thing to get into the temptation, because it is so easily done I might say to divert an enterprise by messing with the tax laws.

Mr. PAUL. May I add something on account of what you said?

In omitting mention of cooperatives, I did not mean to take a position one way or the other.

I merely now wish to confess my ignorance on that subject. It is many years since I have even touched the subject, and my own omission has no significance one way or the other.

Mr. CURTIS. I am glad to know that. Actually as I say I was reading something in this which easily could not have been there.

Mr. CARY. In general answer to your inquiry, Mr. Curtis, I would go along with Mr. Paul's views. I would say that I would go along with you further, that after all it can be said that all provisions in the Revenue Act basically are preferential in one way or another.

I think the thing that is troubling both Mr. Paul and myself and all of us is the trend that exists.

Perhaps it is not beyond control if we could stop today, and not have any more, though it is not ideal. But the thing which concerns us every day is a trend. Every time a new provision goes into the act, someone else has an argument for claiming that he is being discriminated against and therefore that accentuates it.

On the provisions which are supposed to produce an economic effect—you mentioned several of them, including percentage depletion—I, for example, cannot say for sure that I am opposed to percentage depletion in the oil industry.

I know that Senator Douglas did not go that far. He went only to a limited extent. Again, the problem is this trend, because we started with oil.

Perhaps your interest is in the category of oil, let's say, but what about claimshells, what about sand and gravel?

It is this developing accelerating trend that I think worries most of us.

Senator DOUGLAS. May I interject? Would you think there was any danger of drilling dry holes in connection with exploring for sand and gravel?

Mr. CURTIS. That was not the basis.

I do not want to argue percentage depletion here, but there is more sound argument on the other side than that, Senator.

Senator DOUGLAS. I am speaking of sand and gravel.

Mr. CURTIS. I am speaking of that, too, because part of that was covered by the fact that you gradually end up with no sand and gravel, although I question myself on sand and gravel.

Incidentally I might say that is why I voted against turkeys, because I thought the logic probably was there, but I thought in tax law you have got to draw the line somewhere, and some people are going to fall on one side, some on the other.

That does not mean though that I do not want to understand and have sympathy with the person who is just on the other side of the line.

That is perhaps the only emotion I have on this subject, is the lack of sympathy on some people's part for the guy who happens to fall short of the line.

I can decide to vote against him, but I don't want to be unsympathetic with his problem.

Mr. CARY. On the turkeys, I might suggest if you choose a logical explanation you might draw a line between bipeds and quadrupeds.

Mr. CURTIS. It is the investment you put into the thing. The tom turkey has a life of around 16 years or so and they keep them that long and they buy toms not for meat but solely for the purpose of producing their yearly broods, so he does take on the aspect of a capital investment, not meat. I am giving you their argument because I thought they had some sensible arguments.

Mr. BLUM. I think their argument was so good that I would have voted in favor of including the turkeys, but for another reason: I think the vice here is not the discrimination between turkeys and cows, but rather it is the basic distinction between capital gains and ordinary income.

To begin with, I think there are two good arguments for doing something about capital gains.

One is the bunching problem, and as to that the obvious solution is to give taxpayers a spreading out mechanism or an averaging mechanism—not a preferential rate for capital gains but some means of averaging unevenly distributed income.

The other good argument is that we need an escape hatch from the high rates. I think the answer to that is that we ought to do something about the high rates—reduce them.

But once we have adopted the course of giving preferential treatment for capital gains, I am for the turkey industry.

I think the turkey industry has every bit as good a case for preferential rates as the beef industry, or any other industry.

Mr. CURTIS. That is right. You have got to draw the lines.

Incidentally I would have shut my eyes and drawn a line. That was my reaction. Incidentally in many of those things you have to do it.

I think the people in this country would be greatly encouraged in their democratic process if they could actually sit in on a ways and means meeting at any rate and listen to it.

Believe me, it is not an easy thing for a colleague to get across an idea, even though he is representing some little fellow in his own community, and incidentally a little fellow in a community can get a hearing through this process.

This would apply to the turkey farmer. But it is pretty difficult, and I know Mr. Mills can verify it, I certainly can, to get through one of these special provisions in the Ways and Means Committee.

I want to make one further comment along the line that you observed.

It does seem to me that a great deal of these pressures come from the fact that there are four different rates, and it is the differential between the rates that cause most of this shifting.

(1) The 52 percent corporate rate; (2) the zero percent, which is exemptions ;(3) the 25 percent, capital gains; and then (4) this 20 to 91 percent, which goes on up, and if those were more equalized I think there would be a great deal less of this disturbance in our tax structure, even though your net rate might be higher than an average of all of them. But I think—I am not sure we can change it but I am just making the observation, that I think it is the disparities in these rates, the zero, the 52, the 25, and 20 to 91 that applies as a basis.

Were there any further comments on my observations?

I made them so that there would be comments.

I wanted to ask Mr. Atkeson one final question, because you in your original statement, I believe, said you had some recommendations that you had in mind.

I think we would all like to hear them.

Mr. ATKESON. I did not make it quite as strong as recommendations, but I had a few suggestions which I though from an overall administrative standpoint might ease up on the need for special provisions, and I think they bear directly on the subject before us.

For example, in the case of exemptions the 1954 Code made six extensions of the exemption system, such as to the cousin in the hospital, to students that went to day school as contrasted with night schools, and four other special situations. There is going to be continuous pressure on the Congress, I think, to open up this exemption field further. In looking at the statistics of income, I find that in 1952 there were 140 million people included on the tax returns under the present exemption provisions.

That is excluding the old age and the blind categories, so actually you have practically covered the waterfront today with the exemption system now in effect.

Despite this you are going to be up against further extensions from here on out. We have today an extremely elaborate system of personal exemptions which I defy most anybody to really explain to the average person.

I have one form here that the Revenue Service uses in connection with justification or proof of the exemptions. It is form 2038 and it is a fantastic kind of a form, but necessary under the law for the simple reason that the taxpayers have to bring in all these extreme relationship tests.

Prior to 1944 we did not have any of these relationship tests at all. It was a question of did you or did you not support somebody, and if so you were entitled to claim the deduction.

It was a very simple thing to apply, but today far too much money is being spent by employers and employees in this field of personal exemptions for the simple reason that it involves more people than any other one provision of the code.

I would like to suggest that we go back to the old system which we had prior to 1944, and grant the exemption to all on the basis of support without the relationship limitations.

I am not arguing for a change in amount of exemption. I am not saying raise or lower present exemptions. I am just saying make the exemption system more practical by returning to the pre-1944 basis as to who might be claimed as a dependent.

The second item that I have relates to a minimum standard deduction to get rid of all of the complications surrounding the small medical deductions and other types of personal deductions that are causing such a headache from an administrative standpoint at the lower end of the income scale.

A small minimum standard deduction would eliminate that worry and effort.

Third, I would go back to the old law in respect to filing requirements. For example, everybody today with an income of $600 has to file a tax return, whether or not they owe any tax. Now, what sense does it make, really, for husband and wife filing a joint return when you know they are going to get $1,200 exemption, to require them to file a tax return if the income is over $600 but under $1,200? The Congress did make a move in that direction in the 1954 code by saying that if a person with 1 exemption, including their old-age exemption, was $1,200, then they did not have to file a return unless the income was over $1,200.

I would definitely suggest changing the filing requirements to where the income had to exceed the personal exemption, not including the dependent, but the personal exemption of the taxpayer. Thus the filing requirements would be $600 for single persons, $1,200 for married persons, plus in each case the minimum standard deduction, and plus the old-age exemption, which would eliminate 7 to 8 million tax returns that don't bring in 1 cent of revenue.

Fourth, I would definitely urge that you go along with Mr. Paul's recommendation, and Professor Groves' recommendation, on the withholding of tax from dividends and interest. Just to give you 1 illustration, if you look at Statistics of Income you will find about 5 million people reporting interest in their tax returns, but when you think of only the investors in E bonds, you would get far more than any 5 million people. It is a little ridiculous from the standpoint of compliance. The Revenue Service, of course, can't be expected to go out and police a system of the type that we have for the simple reason that they can't afford to chase pennies, so the only way to get at this type of income would be through some withholding system.

Fifth. The Congress, to my mind, if you will permit me to say so, made a mistake last year in eliminating the information return requirements from the standpoint of reporting transactions in the nonbusiness area. In other words, the information provisions were loosened up so as to excuse people from filing forms 1099 in respect to payments made as between certain persons.

Mr. Curtis. May I interrupt on that? I would like this for information: We had the people from the Bureau before us on those information returns.

Mr. Atkeson. I was there, sir.

Mr. CURTIS. The question we raised was whether they used them, and the information seemed to be, of course, that it sounded good but no one was using them. Your position is that even though they weren't using them, they could be used; is that right?

Mr. ATKESON. My position is that the law should require the filing, and, of course, it is up to the Administrator to follow through and use them.

Mr. CURTIS. I meant from a practical standpoint, can they be used? That is the point.

Mr. ATKESON. Yes, sir. They definitely could be used. Now I would have to say to you that they have to take their order of priority from the standpoint of available manpower that the Commissioner has, but if the Congress were to do these other things, which would clarify, simplify, and mechanize this whole job, there would be ample elbow room and time for the Commissioner to do that.

My sixth suggestion concerns the relationship between the social security and the income tax. You have a big agency collecting insurance premiums and another agency of Government paying out benefits based on the insurance premiums.

It seems to me that from an overall governmental standpoint, these two big systems of collecting premiums and paying out benefits should be more closely coordinated from a mechanical standpoint to tie in the tax collection under the law with the benefit payments. The Revenue Service is chasing people all over the country trying to collect delinquent taxes, while at the same time the Social Security Administration is by law voluntarily mailing out Government checks to many who owe taxes. The Congress did, by the way, make some changes last year which were helpful from the collection standpoint in the matter of permitting the levy against Government salaries.

Seventh. I want to indicate full-hearted endorsement of Mr. Surrey's suggestions in the capital-gain area. These appear on pages 417–418 of the volume containing our papers. I think there is quite a bit in there that would help administratively to carry out the law.

Eighth. In connection with the audit of corporation tax returns and all of the present complexities relating to the computation of corporate taxes, I believe that we have about reached that point where there should be some other device developed for arriving at the tax liability, other than through the more detailed and complex audits that have to be made. Perhaps an alternative tax could be provided for corporations on the basis of a certain percentage of their net earnings as reported to their stockholders in the case of publicly owned corporations, in lieu of the present statutory definition of income, which could be administered much more easily than the present type of system. The normal pull of the stockholders for high earnings would tend to make the system self-policing. The tax rate would be slightly lower than that applied to the statutorily defined base. This would tend to make audits automatic as compared with the present laborious system.

And finally, I would like to call attention to the fact that I think that this matter of having treated the retirement income and pensions the way they have been treated in the 1954 Code is going to cause considerable amount of trouble in the years ahead, when that type of

income is going to comprise such a large segment of our national income.

You have more or less tied your hands by the present method of treating it; namely, making the taxes payable on the income when it is earned and then allowing for a pro rata exclusion under the method by which it is currently reported. For example, if you wanted to tax this large segment of income here heavier under emergency situation, you are pretty well stuck with this exclusion ratio that we have today.

In other words, it would have been far simpler all the way around if the cost had been taken as the income was earned, and then the full amount of the annuities and retirements taxed just as any other type of income would have been taxed in the years ahead. This applies to social-security payments as well as to other types of retirement income. That is all I had.

I would be glad to develop these, but I am sure your time is running out.

Mr. CURTIS. Mr. Chairman, could I make a suggestion, that when your statement comes for your edition, that you do add on additional data that you would like to put in.

Mr. ATKESON. I would be very happy to fully develop it if you desire.

Mr. MILLS. Without objection, that will be done.

Mr. PAUL. Are those tables I provided for the committee to be inserted in the record?

Mr. MILLS. Yes. Permission was given for those tables to be included.

Mr. MILLS. Are there further questions?

Any further statement by a member of the panel?

If not, the subcommittee adjourns until 2 o'clock this afternoon.

(The following letter was later received for the record:)

SOUTHPORT, CONN., *December 7, 1955.*

Hon. WILBUR D. MILLS,
Chairman, Subcommittee on Tax Policy,
House of Representatives, Washington, D. C.

DEAR MR. MILLS: I received last week a copy of the volume, Federal Tax Policy for Economic Growth and Stability and the London Economist of Saturday last, which reached me yesterday and brought my attention to the contribution made by Prof. William Cary. Here I found on page 272 a reference to myself which reflects a misconception of what I said in a talk about the taxation of capital gains—not on the revenue process—at the Tax Institute in 1946. A similar (apparently the original) reference appears in Mr. Randolph Paul's paper on page 306.

I enclose an extract from the report cited by Mr. Paul containing the discussion from which he quotes a single sentence which I have italicized; and also an extract from my remarks at the conclusion of the session. Doubtless you have the full report ready to hand. From these extracts it will be seen that both Professor Cary and Mr. Paul have given to what I said a wider application and a different significance than the language bears.

I suggest that as regards capital gains, the only subject with which I dealt, the whole discussion of disuniformity by Professor Cary and Mr. Paul suffers from the fatal logical defect in that it begins by making an assumption which stands in as much need of proof as the conclusion which they draw; the assumption that there is a natural standard of uniformity which is applicable to income taxation.

The distinguished economist, Edwin F. Gay, has pointed out that the social sciences are still in the pre-Linneum stage and that no one has established a

classification of concepts and phenomena in this field by families, genera, and species.

And certainly, under any uniform classification, losses would appear as negative items in the classification in which gains would appear as positive elements. In my many years of intimate association with leading tax authorities in the United States and Great Britain, I have never met anyone who was so rash as to recommend a system having any such uniformity as a law for taxation of capital gains.

I believe that the Study Group on Concepts of Income which made its report under the title, "Changing Concepts of Business Income" in 1952, was correct when it said:

"A flow of income and a change in the value of expectations would seem to differ in essential characteristics sufficiently to make their treatment in separate categories desirable, even though each may be regarded as an appropriate subject for taxation."

It went on to say:

"The British Inland Revenue Authorities in 1920 took the position that if capital gains were to be taxed, the levy should not be made under the income-tax law."

The treatment of capital gains was a subject of consideration by the recent British Royal Commission on Income Taxation. Both the majority and the minority rejected as unsound and impracticable all proposals to make the taxation of capital gains an integral part of a system of progressive income taxation.

I would agree that the concept of capital gains has been extended too far; but the remedy is not to revise the whole system on the basis of uniformity. Most advocates of heavier taxation, including the minority of the British Royal Commission, favor adoption of the fiction that death constitutes a realization of assets by the decedent during his life. This is one of the arguments that led me to recommend that so long as the present system continues, the income tax, the gift tax, and inheritance tax should be considered as a group and not separately.

I shall not carry this discussion further because my present object is to correct an erroneous impression which the contributions of Professor Cary and Mr. Paul may have created. I should, of course, be glad to furnish a fuller statement of my views on any question before the committee if they should desire it, as I have done on many occasions in the past.

Respectfully,

GEORGE O. MAY.

CAPITAL-GAINS TAXATION (P. 21)

As you probably surmise, there is very little in what Professor Groves has said with which I should agree, but I don't want to go over the whole ground. I don't agree that it is unimportant whether capital gains are income. I think whether they should be taxed or not is a much more important question, but I think there is a great deal that is undesirable in taxing them as income for various purposes. I think it is a great mistake on the part of our people to regard capital gains as income that should be spent as income, because it is my experience that the great bulk of capital gains are lost, contrary to Mr. Seltzer's observations. Of course, a few people continue to make capital gains, but I think the number of people who lose at one time what they make at another time is much larger than Professor Seltzer seems to think and includes some of the shrewdest investors. I think Mr. Seligman would agree on that.

Of course, I was born in a country (England) where capital gains are not regarded as income for any purpose. People don't regard them as income, and tax authorities don't regard them as income, and that is an attitude you don't grow out of very easily.

Professor SELTZER. Sometimes they have differences of opinion as to what is capital gain.

Mr. MAY. There are attempts to convert ordinary income into the form of capital gains and the authorities have to be constantly on the guard to protect themselves against that, but in principle the English have never favored the taxation of capital gains, at least under the income tax. My view would be the same as that of Sir Richard Hopkins, who recently retired as head of civil service and was formerly chairman of Inland Revenue. His view was that Inland Revenue, if called upon to tax capital gains, would prefer to do it outside the income-tax law. I certainly regard that as a preferable approach.

I think that is so, but personally I regard the income tax, gift tax, and inheritance tax as all parts of a system which has two double purposes of raising revenues and correcting maldistribution of income. I think they are all part of a system. In fact, when I was talking to a group of Congressmen one day, I said I thought it would help if they looked at this like a ball game. You have your forward line of defense and secondary defense, and then you have your fullback. *If you try to stop all the plays in the line, you won't have a game.* You have to let someone get through the line and score a touchdown occasionally or you won't have a game.

If you regard income tax and inheritance tax and gift tax as all part of the defense, interrelated, you get a sounder scheme than if they are regarded separately. I hold the philosophy that capital gains are usually lost, which is what happens to most; and if not, they become subject to the gift or inheritance tax or something of that sort, so that in the long run, as a matter of social policy and as a question of revenue, I would not tax capital gains or allow capital losses as a deduction; but I think it is almost politically necessary to tax capital gains. Therefore, I would rather be in favor of it, but I have tried to find a way of doing it outside of income taxation.

CAPITAL GAINS TAXATION (P. 96)

Mr. May. I find myself in the somewhat unexpected position of very largely agreeing with Mr. Seligman. I regret to conclude that it is necessary to tax capital gains, but I think you can't approach capital gains until you successfully start with some social philosophy. If the constant effort is to diminish the share of those who have saved in the past in favor of those who make current contributions and of consumers, then heavy taxation of capital gains is obviously a method of making that very effective, and that is one point.

The second point I would make is that I feel that the tax system as a whole has to be considered. As I said earlier, you have to make it possible for a man once in a while to make a touchdown. If you try to stop the game at the line of scrimmage, you never get a real game, and for that reason I would say, other things being equal, I would rather add to inheritance taxes and reduce the taxes on capital gains in terms of a fairly long holding. That is the kind that I think I want to relieve from a tax on capital gains so there will be encouragement to the entrepreneur. I regret some of the effects on the poor widow. I feel that it is rather shocking for the Government to reduce artificially the interest rate and tell the poor widow who is living on her income that she has gained from that action when she knows the contrary to be true. But I think that should be covered in some method of relief.

(Whereupon, at 12:55 p. m., an adjournment was taken to 2 p. m., same day.)

AFTERNOON SESSION

The subcommittee met at 2 p. m., the Honorable Wilbur D. Mills, chairman of the subcommittee, presiding.

Present: Senator Paul H. Douglas.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. Mills. The subcommittee will come to order, please.

This afternoon's session of the Subcommittee on Tax Policy will be devoted to discussion of the relationship of exemptions and deductions in the individual income tax to economic stability and growth.

As announced this morning, our procedure is to hear from panelists in the order in which their papers appear in the compendium. At the start of each of these sessions, panelists will be given 5 minutes each to summarize their papers. We will hear from all panelists without interruption. The 5-minute rule will be adhered to. Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session. I hope that this part of the

session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers of other panelists, as well as answer subcommittee members' questions.

Our first panelist this afternoon is Mr. Daniel M. Holland of the National Bureau of Economic Research.

Mr. Holland?

Mr. HOLLAND. Mr. Chairman, Mr. Kahn and I submitted a joint paper. I was responsible for the first portion of that paper and it is to that which I am now going to speak.

Let me emphasize first that Mr. Kahn and I are here as private individuals and not as representatives of the organization for which we work—the National Bureau of Economic Research.

How large is the annual flow of income to persons?

How much should they report on tax returns?

How much actually does show up on tax returns?

To these direct and simple questions it is not possible to give precise and unqualified answers. Conceptual difficulties and the fact that the data are subject to ranges of error preclude this. However, the relevant magnitudes can be sketched out with a broad pen, thanks, in large part to the personal income data published (or made available) by the Department of Commerce and the careful estimates prepared by Dr. Joseph A. Pechman, and generously made available to me.

In 1952, the most recent year for which we could make such estimates, the personal income receipts of individuals came to $271 billion, while individuals reported adjusted gross income of $215 billion on tax returns. Apparently $56 billion was "lost" somewhere between its receipt and the tax collector. But this is too hasty a conclusion. For there are differences in what comes under the scope of these two income concepts. The components of personal income not included in adjusted gross income (primarily social-insurance benefits and other Government pensions, employers' contributions to private pension and welfare plans, income in kind, nontaxable military pay and allowances, and imputed interest) totaled $39.4 billion. On the other hand some $8 billion (primarily employee contributions for social security and capital gains) that was included in adjusted gross income was excluded, by definition, from personal income. So we can explain $31.4 billion of the $56 billion gap on a definitional basis.

But what about the remaining $24.6 billion?

How can we explain it? By four factors:

(1) The income receipts of those whose income was so low (under $600) that they did not have to file tax returns;

(2) the income receipts of those who, being nontaxable because their exemptions and deductions exceeded their income, did not have to pay tax and, therefore, even though legally required to do so, failed to file returns;

(3) underreporting either purposeful or through oversight; and

(4) statistical error—for neither the Department of Commerce income estimates nor the tabulations in Statistics of Income are precise figures.

As regards (1) and (2), it should be noted that many of those with less than $600 of income nevertheless filed returns for refund because taxes were withheld on their earnings. It is very difficult to come up with any figure that is at all accurate. But a very rough

estimate would put the sum total of AGI under (1 and (2) at between 1 and 2 billion dollars. This leaves us with something like a gap of $23 billion due to underreporting and statistical error.

We conclude that something on the order of 10 percent of AGI remains unaccounted for. Waiving aside statistical error which is impossible to isolate, only this relatively small fraction of the total gets lost between its receipt and the tax collector. It is possible to view this in a comfortable light. Taking an expansive view, it could be argued that any social device that achieves 90 percent of its purpose is doing mighty well. But, before we get too complacent about it, a note of warning should be sounded.

First, the absolute size of the unexplained residual is not unimportant. Undoubtedly, could it be traced, a significant addition to tax collections would ensue. But at least equally disconcerting is this consideration: The behavior of the aggregate masks significant diversities in its components. The degree to which underreporting exists varies markedly for the different sources of income.

By far, the major portion of income arises as wages and salaries. As regards this source, the opportunities for underreporting are at a minimum, since the tax is withheld at source for most wage earnings. For 1952 we estimate that about $18 billion of wages and salaries should have shown up on tax returns, while from the returns filed we can account for about 95 percent of this total.

So 95 percent of what should have been reported actually did show up. This is the same degree of coverage that Selma Goldsmith found for 3 earlier years, 1944–46.

As we shall see, this is a noticeably higher coverage ratio than for any other type of income.

Dividends, to a greater extent than any other source of income (except capital gains), flow to those with higher incomes. Yet, the proportion of dividends that shows up on tax returns is lower than for wages and salaries. From an examination of the data for 1952, we found that only 87 percent of the dividends that should have shown up on tax returns actually did. Some 13 percent, over $1 billion, eluded the tax mill. It is interesting to compare this figure with a similar type of estimate made for an earlier year.

For 1941, when exemptions were higher and only half as many returns as in 1952 were filed, Richard B. Goode found that only 6 percent of personal dividends could not be accounted for. It is hard to escape the conclusion that individuals' propensity to report dividends suffered a decline starting with the high tax rates instituted during the war. Very rough computations suggest that the decline in the degree to which dividends were reported commenced in 1942; the reported percentage reached a low in 1943 and 1944 and then started to rise again, but by 1952 it was still well below its 1941 level.

Turning to the monetary interest receipts of individuals we find a strikingly lower degree of reporting. Our estimate for 1952 is that only 39 percent of what should have been reported on tax returns actually showed up thereon. In this respect, interest shows a lower degree of reporting than any of the other specific sources of income that are investigated in my paper (with the possible exception of farm income which is discussed below).

We estimated the amount of interest that should be reported on tax returns at $5.7 billion, the amount that showed up as $2.2 billion; the gap as $3.5 billion. Aparently the fact that much of personal interest takes the form of small payments (or just bookkeeping entries as in the case of savings bank deposits) from a variety of sources helps to explain the difference in the degree of reporting between dividends and interest. Another factor is that interest receipts to a much greater extent that dividends flow to lower-income stockholders whose recordkeeping is meager and who are less apprehensive about the possibilty that their returns may be audited.

So far we have spoken about wages and salaries and two types of income from property. The last income type reported on—entrepreneurial income—is really a composite of labor and property income.

Individual proprietors and members of partnerships perform functions whose payments encompass returns both to labor and capital. For 1952, we estimate that about $35.1 billion of entrepreneurial income (income of sole proprietors and partners) should have shown up on tax returns, but we were only able to find $24.7 billion reported thereon. Some $10 billion or so disappeared for tax purposes. Only about 70 percent of what should have been reported actually was. It is interesting to note that the amount of wages and salaries not reported was slightly less (about $9.6 billion) than the amount of entrepreneurial income not reported, yet wages and salaries totaled more than five times as much as entrepreneurial income.

Our entrepreneurial income-reporting percentage for 1952 is not very different from Selma Goldsmith's finding of 66, 68, and 66 for 1944, 1945, and 1946, respectively.

Within the category of entrepreneurial income there is a significant difference between the degree of reporting of farm income and business and professional income. The data are not available for making such a breakdown for 1952. The most recent year for which this could be done is 1947. Using the same methods employed in the 1952 estimates, we found a reporting percentage for all entrepreneurial income of about 66.

For the farm-income component, however, the reporting percentage was only 38.5 percent. Slightly less than $6 billion of the $15 billion that should have been reported appeared on tax returns. The rest of entrepreneurial income—business and professional income—was characterized by a much higher reporting percentage. About $19.5 billion should have been reported, while a little over $17 billion showed up, leading to a reporting percentage of 87.5.

These values are very close to Selma Goldsmith's findings for 1945. While nothing can be said with certainty about the trend since 1947, it is likely that these differentials still exist.

In the table below we sumarize the results of our investigation of the various income types. No great accuracy is claimed for these figures. But they are probably substantially correct, and show, without question, that significant variations exist in the zeal with which the various types of income are reported for tax purposes.

Estimated nonreporting of various types of income, 1952

Source of income	Amount not reported that should have been reported	Nonreported as a percent of total income from this source
	Billions of dollars	*Percent*
Wages and salaries	$9.6	5
Dividends	1.1	13
Interest	3.5	61
Entrepreneurial income	10.4	30

Finally a word on income-splitting on which C. Harry Kahn and I worked jointly. First, let me apologize for some errors in computation detected after our paper had been printed. We erroneously reported that in 1951 some 20.3 million or 83.5 percent of all taxable joint returns failed to benefit from income-splitting, and that the less than 10 percent of all (separate and joint) taxable returns for whom income-splitting meant a lowering of tax liabilities received 37 percent of taxable income. The correct figures should be: 13.1 million or 52.3 percent of taxable joint returns obtained no tax benefit from income splitting, while the less than 29 percent of all (separate and joint) returns who did have lower tax liabilities because of income-splitting received 59 percent of taxable income.

Now, for the rest of the story, very briefly. In 1951 had married persons been subject to the same rates as single taxpayers (by, for example, continuing income-splitting and requiring that families report their income as a single unit but halving the rate brackets applicable to separate returns), income-tax revenue would have increased by about $2.5 billions. Or, alternatively, the following changes could have been made in the income-tax structure without a loss in revenue.

First, exemptions could have beeen raised by $100. This would have provided relief concentrated in the lower income brackets. Alternatively, a flat limitation of about 40 percent could have been placed on marginal rates, that is, the highest marginal rate would have been no more than 40 percent, the rest of the rate schedule to this point remaining unchanged.[1] This would have meant relief concentrated in the upper-income brackets, and would be in line with the suggestions of those who emphasize the disincentive effects of high marginal rates of tax.

Or, finally, the whole rate schedule could have been cut by about 2.5 percentage points in every bracket. (This is almost equivalent to dropping the normal tax and keeping only the surtax rates.)

While these conclusions are based on the 1951 data, they are probably descriptive of today's relative orders of magnitude as well. (The 1955 absolute tax saving due to income-splitting may be between $500 million to $1 billion higher than for 1951.)

Mr. MILLS. Our next panelist is Mr. C. Harry Kahn, National Bureau of Economic Research.

Mr. KAHN. Mr. Chairman, in recent years two magnitudes have stood between total adjusted gross income (the amount of income that would have been reported if every income recipient had filed a return)

[1] This figure was erroneously given as 50 percent in our paper.

and the tax base. They are the personal deductions and the personal exemptions. The personal deductions cover primarily nonbusiness expenses such as philanthropic contributions, interest payments, State and local personal taxes and medical expenses. The exemptions per tax return amount to a multiple of $600, and they vary in the main with family status and the age of the taxpayer and his spouse. Were it not for these two types of reductions, adjusted gross income would, in effect, constitute the tax base.

How large is the gap between total adjusted gross income and the tax base? In 1952, when total AGI was estimated at close to $240 billion, the tax base amounted to $105 billion, leaving us with a gap of $134 billion. This gap is explained by an estimated $83.6 billion of personal exemptions, $26.8 billion of personal deductions[1] and about $24 billion of underreporting or statistical error. In other words, in the most recent year for which we have reasonably reliable data, the personal exemptions reduced the potential tax base by somewhat over one-third, and the personal deductions reduced it by over one-tenth. While the relative size of the reduction of the tax base due to personal exemptions has declined over the years, that for personal deductions has been on the rise. In 1939, for instance, the exemptions accounted for almost two-thirds of total AGI, but the deductions for a mere 7 percent.

These figures reveal two important features in the development of the modern income tax:

1. They show that the amount of income eliminated from the tax base, by statute, within the aggregate that is conceptually designated as the tax base (as opposed to income types that lie conceptually outside the tax base, i. e., are not included in adjusted gross income) is still very large. While it declined from 72 percent in 1939 to 46 percent in 1952, it also means that, when we include leakage due to underreporting errors, we were left with only 44 percent of total AGI in the actual tax base. So, less than half the income that conceptually constitutes the tax base actually is subject to tax.

2. The figures reveal a change in the composition of the amount of AGI removed from the tax base. It is less than formerly related to family size, that is, population, and more to certain types of personal expenses, and even size of income.

What does the gap between adjusted gross income and the actual tax base mean in terms of tax liability? To illustrate the magnitudes involved, we have computed the tax liabilities that might have resulted in 1951 with four types of tax bases. With the tax base that permitted both deductions and exemptions, the total tax liability was about $24.2 billion. With a tax base that would have permitted neither, that is, all of AGI taxable, $48 billion in liabilities would have resulted. Thus, even though the tax base would have more than doubled, tax liabilities would have fallen slightly short of doubling. This is because the relative increases in the tax base would, of course, be greatest at the bottom of the income scale. The same would hold even if deductions alone were eliminated despite the fact that deduc-

[1] This figure includes a probably small amount of expenses incurred in the production of income, which should, from a conceptual point of view, have been deducted before arriving at adjusted gross income, but are for administrative reasons included in the "miscellaneous personal deductions" category. It consists of such items as expenses in connection with the taxpayer's job, amortization bond premiums, and safety-deposit box rentals.

tions are a fairly constant percent of income throughout the income scale and the rates progressive.

The elimination of the deductions would have produced an increase in tax liabilities of $6.1 billion, or 25 percent. Viewed alternatively, the increase in tax base, due to eliminating deductions, would have permitted a rate reduction of roughly 20 percent for all brackets and would still have produced about the same total tax liability.

What has been the composition of the personal deductions aggregate in recent years? Since 1944, a major part has been taken in the form of the standard deduction, due to the generosity and the convenience of the latter. But in 1952 it has for the first time fallen to less than one-half the total dollar amount of deductions claimed on taxable returns. Over 63 percent of the total were standard deductions in 1944, but since then the shift back to itemizing has been a surprisingly steady one.

This is not only due to the sharp increases income, which carried many taxpayers beyond the income range in which the 10-percent optional standard deduction is operative, but also to the growth in the type of expenditures that are allowable. Both in absolute terms, and relatively to income, the philanthropic contributions, taxes paid, interest paid, and medical-expense deductions have been on the rise. The most spectacular increases seem to have occurred for interest payments due to the postwar developments in consumer debt, interest rates and home ownership. As a deduction it exceeded in 1952 the medical expenses on taxable returns for the first time since 1944. The medical-expense deductions are relatively small due to the operation of a minimum exclusion, which is a constant percent of income. Thus, while the philanthropic contributions are well over one-half, and the interest-paid deductions close to one-half, of their underlying country-wide aggregates, the medical-expense deducations amounted to only one-fifth of their country-wide total.

As we have already noted above, the deductions have in the past constituted a fairly even percentage of adjusted gross income for the various income size groups (in contrast to the exemptions, which decline sharply relative to income as we move up in the income scale). This tends to be true also for each of the major deductible items individually, except for the medical-expense deducations, which decline sharply relative to income as the latter rises due to the minimum exclusion. We may conclude from this observation that as incomes continue to rise in this country, taxpayers will also continue to move out "from under" the standard deduction, and return to the practice of itemizing, unless its upper limit is revised periodically.

Mr. Mills. Our next panelist is Mr. Paul Strayer, professor of economics, Princeton University.

Mr. Strayer.

Mr. Strayer. First, I want to congratulate the subcommittee under the leadership of Chairman Mills and his staff and my fellow economists for what I think is the most useful set of tax hearings that I have yet seen. I mean this sincerely.

Mr. Mills. We are deeply gratified.

Mr. Strayer. I want to talk about the significance of exceptions and deductions for the low-income taxpayers.

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The most significant effect of the level of exemptions under the individual income tax is that of determining the size of the tax base. Previous panelists have indicated some of the magnitudes involved with current exemptions.

High levels of exemption decrease the tax base. Low exemption levels increase the tax base. In a similar fashion the generosity of the tax authorities with regard to deductions will affect the base against which tax rates are applied. So long as revenue requirements continued at present levels an increase in exemptions or deductions would require the imposition of some other tax. On the other hand, if tax reduction becomes possible a decision to raise exemption levels or deductions must be made only after the reduction in other taxes is considered. In spite of the many imperfections of the individual income tax it is to be preferred to most other sources of Federal revenue and it is generally agreed to be superior to the miscellaneous excise tax system that has grown up over the years. We may conclude, therefore, that if tax reduction is possible priority should be given to the reduction or removal of the discriminatory indirect levies.

In the event that a contercyclical tax reduction or increase is desired changes in rates are to be favored over changes in exemption levels. This position is based upon the belief that rates that have been lowered can be raised again as required by economic developments more readily than can exemptions once raised be lowered as events require. The administrative advantage of rate variation is great. A change in exemption levels will affect many thousands of taxpayers at the margin and unless made to coincide with the tax year would involve a great increase in tax refunds or additional payments.

Low exemptions and high rates of taxation have led to much criticism of the tax as imposing an undue burden upon those in the lower income brackets. Much of this criticism is based upon the belief that a minimum of subsistence should be completely exempt from taxation. So long, however, as indirect levies play the role that they do, subsistence will continue to be taxed. Priority should be given to the deduction or removal of these taxes before exemption levels are changed. Until this is done there is no possibility of having a tax system that either exempts a minimum of subsistence or even imposes a progressive tax burden throughout the income structure.

The major sources of inequity arising under current practices are found in the comparative burden imposed upon the single and the married, and the uneven impact of the law upon different occupational groups and different sources of income. The latter problem can be met only as more effort is applied to the administration of the tax and as the law is revised to close the legal avenues of tax preference that have been growing in recent years. The former problem of the comparative burden upon single and married couples is impossible to solve to the complete satisfaction of all but it is suggested that a narrowing of existing differentials is desirable. This could be accomplished by reducing the width of the brackets for married couples making joint returns.

One of the greatest improvements in the Federal revenue system which has resulted from the greater dependence upon the individual income tax has been the increase in the sensitivity of tax yields to changes in national income. Both exemptions and progressive rates

are effective in creating this sensitivity. Thus, there has developed a built-in stabilizer which, although not sufficient to offset all fluctuations, can be useful in minimizing the problem. Any action which would reduce this flexibility should be opposed. The claim that current exemption levels threaten the maintenance of consumer demand necessary to maintain a full employment economy cannot be proved on the basis of recent events. If there is need for strengthening of demand priority should again be given to the removal of excises. It is also necessary to consider the effect of taxation upon investment as well as consumption. In the event that real deficiencies arise a general tax cut granting concessions across the board is favored as against a cut favoring a single group.

Tax burdens on all income groups are high because Government expenditures are high and stability of the economy requires the restriction of consumer and investor demand to make possible the achievement of Government objectives without inflation. We should be proud of the fact that in face of such extraordinary demands we have been able to use the income tax as the primary source of revenue. As a result both the economic repercussions of the heavy tax burden and the equity with which it is imposed are relatively favorable.

Mr. MILLS. Our next panelist is Mr. Melvin I. White, professor of economics, Brooklyn College.

Mr. White?

Mr. WHITE. The purpose of developing and using a logically tight definition of income in personal taxation is, simply stated, to provide a short-cut to fairness.

In a complex modern economy, individual economic circumstances differ in a multitude of ways, and unless a clear concept of income is available as a guide it is easy to get sidetracked into a maze of individual equity relationships without progressing toward the goal of equality of treatment of all who are truly equally circumstanced.

The income concept is important also for the proper treatment of unequals. If statutory rate schedules are to be relied on to control progression in an open and aboveboard way it is necessary that the tax base itself represent an acceptable index of economic status and be defined with a minimum of ambiguity.

Finally, the logic of income definition helps to clarify any cost in equity which should be balanced against the gain from tax policies intended to promote economic stability and growth.

Personal income has been given its most rigorous definition by the late Prof. Henry Simons. Stated with extreme succinctness it is the algebraic sum of valuable claims exercised on behalf of consumption plus the net change in stock of claims for a given period.

Explication of the definition itself cannot be done within the time now available and therefore I shall devote my further remarks to summarizing implications of the concept for the treatment of personal deductions and exemptions.

The provisions for personal exemption and credit for dependents in large part have the purpose of discriminating among households of varying membership. Insofar as a man and wife are concerned, a per capita or equal-partner approach is implied in the split-income provisions of the present law which permits the total income to be divided by 2 before determining the appropriate tax rates.

An extension of this approach could efficiently replace the present credits and head of household status.

However the divisor should be adjusted to allow for economies of scale as the household grows in size. Thus even for a couple, the divisor should really be less than 2, and technically should increase by diminishing fractions for each successive member of the household, with the increase less for minors than adults.

The deprogressive effects could presumably be offset by appropriate rate adjustments.

The services provided by the nonworking wife in the home are part of economic income, but not susceptible to tax. The special deduction for working wives and single parents represents a partial offset to the discrimination against them. However, the deduction is justified on a strict equity basis whether explicit expense for domestic service is incurred or not, and whether or not child care is involved.

The essential issue raised by mortgage interest and property taxes is the discrimination against the tenant that inheres in the present law. The discrimination arises because there is a tax-free income in the form of net rent imputable to the homeowner that is not available to the tenant. It could be remedied by requiring an estimated net imputed rent to be added to the taxable income of the homeowner.

Property taxes and mortgage interest deductions as such would be disallowed although they would be permissible expenses only if net rentals are computed as gross rentals less expenses. It would be easier, however, to compute net rentals from an imputed rate of return on the net equity.

Without inclusion of such net rental imputations, there is no clear-cut criterion for the treatment of mortgage interest. To permit the deduction puts a borrower-owner on a more equitable basis with a clear-owner but aggravates the inequity to the tenant, whereas to remove the deduction would put the borrower-owner further from the clear-owner but closer to the tenant.

This situation, by the way exemplifies the difficulties of attempting to solve equity problems on a partial basis; that is, without reference to the underlying income concept.

Personal and installment interest involve similar ambiquities. It may perhaps be argued that on balance a larger measure of equity may be served by continuing their deductibility.

With regard to State and local taxes, the logic of income definition implies differential treatment of excises and income taxes, disallowing the deductibility of the former but permitting deductibility of the latter.

This may induce more widespread adoption of income taxation at the State and local level, thereby increasing the sensitivity of State and local fiscal structures to changes in the general level of incomes.

From the point of view of national stabilization policy such a development would on the whole be desirable. And if combined with better planning and the use of reserve funds, it would be an improvement from the State and local point of view as well.

Consistency with net income is not the significant issue in the handling of medical expense and casualty loss deductions. These deductions are an expression of a community desire to protect against involuntary risk. They may be considered as a kind of insurance, covering otherwise uninsured contingencies to person or property, with

the premiums reflected in higher tax rates than would be necessary without this deduction.

So regarded, the system probably works out to be biased in favor of the upper income groups. The significance of the deductions will of course decline sharply once the community works out some acceptable form of direct medical insurance.

Deductions for contributions to philanthropic institutions obviously are not implied by a net-income calculation, but they are an important instrument in restraining the direct role of Government in the conduct of social-welfare activities and in developing alternative private sources of funds.

The technique of a fractional credit against the tax bill would be more democratic in its effects than the present deduction from taxable income.

Finally, the present optional standard deduction is essentially functionless and somewhat misleading as an instrument of equity. Its effect is to put a very high floor under the total of eligible deductions and thus to make the system of personal deductions, which is essentially a selective concept, nonoperative over a wide range.

Mr. MILLS. The Chair would like to thank each panelist for his appearance and contribution, made in the compendium and in his statement today, to our thinking on the subject of tax policy.

We appreciate very much the effort that all the members of all the panels have made in making the compendium, we think, a prospective best seller.

I think it becomes a best seller, doesn't it, if it is a Government publication and if at least a thousand copies have been sold in a period of a few weeks after it becomes available?

Mr. STRAYER. I hope it sells for many years.

Mr. MILLS. We do, too.

Mr. Holland and Mr. Kahn, I would like to direct a question to the two of you first: Does the fact that the individual income-tax base does not include all personal income, as you have used the term, have significant implications for the allocation of resources?

I am not urging either one of you to jump in ahead of the other but if one of you will, it will be appreciated.

Mr. HOLLAND. Many of the items not included in the tax-base definition of income, but that are included in personal income, many of those items I think are not of direct importance.

Mr. MILLS. Which of them are?

Mr. HOLLAND. In this connection, I think the two items people point to most frequently are, as Mr. White mentioned, the imputable income from housing, the exemption of which affects the status of ownership and use of resources in connection with encouraging homeownership, and another item which is small in total amount—tax exemption of interest from State and local securities.

Nevertheless, it is pointed to as being important in connection with the question you raised.

A subsidy, in effect, is given to those taxpayers whose marginal rates are higher than the rates just sufficient to make it profitable for someone to undertake the purchase tax-exempt securities as compared with investments that might yield a higher return prior to tax but not after tax.

You have to push pretty far down the rate schedule to get the stock of tax exempts in toto taken off the market.

Some people who are higher up the rate schedule will get a differential tax advantage in that connection. Of the items that represent the gap between personal income and adjusted gross income, these are the two frequently cited.

An additional consideration is that adjusted gross income itself carries an ambiguous definition of capital gains, since it includes only half of realized long-term gains. That is a matter that was discussed this morning.

Mr. MILLS. Mr. Kahn, which of the deductions you discussed are important in the sense of the way taxpayers use their resources?

Mr. KAHN. Well, it is, of course, very difficult to quantify that sort of thing. All we know is how large they are. To what extent the deductions offered to homemakers, for instance, in the sense that they can deduct their mortgage interest and their property taxes, induce people into homeownership is very difficult to say.

There is undoubtedly some awareness on the part of prospective purchasers of homes that they will have an imputed nontaxable income, in the sense that they will own an asset the income from which is not taxed, and also that they will be able to deduct their property tax and their interest, and that is at least a 20-percent contribution on the part of the Federal Government. Another thing that is talked about a good deal—again I do no know how important it is quantitatively—is the cooperative apartment house projects that enable the coowners to deduct their pro rata share of taxes and interest, and that is undoubtedly an inducement to high-bracket taxpayers, if they choose to live in an apartment, to live in a cooperative-apartment project.

I would say, although this may not be exactly to the point, that whenever these deductions perform a subsidy function, whenever they have an incentive effect, the thing that one might most object to is the fact that the subsidy increases as you move up the income scale.

Mr. MILLS. Do you have anything further to add on that point?

Mr. KAHN. Pardon?

Mr. MILLS. Do you have anything further to add on that point?

Mr. KAHN. I think I have pretty much covered it.

Mr. MILLS. What about deductions for charitable contributions?

Mr. KAHN. If you are asking me whether deductibility has an effect on the amount of resources going into that area, that is, the area of activities covered by philanthropic organizations, I have no doubt that that, again, has some effect.

I think a great many people, however, make contributions regardless of whether they get deductibility or not.

Mr. MILLS. We are discussing the possibility of having an effect upon uses of resources, and I think you are saying that deductibility for charitable purposes could have such an effect to some extent.

Mr. KAHN. Yes. That is right. There is a definite incentive element involved.

The only reason that I am somewhat cautious is because I really have no quantitative evidence for that.

Mr. MILLS. We don't attribute improper motive at all. We are talking about what may happen as a result of a very proper motive to make a contribution.

We don't say that it is the motive initially of affecting resources that may cause the individual to be encouraged to contribute to charity.

I don't mean to put that in your thinking.

Certainly I don't want it considered that way. We are talking about the after effects of a very laudable motive to contribute and the effect it may have on use of resources primarily.

Let's be clear in the record.

We are not deploring the fact that people do make contributions.

Mr. KAHN. I understand.

Mr. MILLS. Mr. White?

Mr. WHITE. I would like to make one observation in connection with the impact on resource allocation. It is the general one that any action that results in a lower or higher price to the purchaser, will have some effect on the allocation of resources and on the distribution of income.

The effect will depend both upon the particular type of demand that the purchasers have for the product and will also depend upon the conditions of supply. It is hard to say where and how in the economy the effects will manifest themselves.

Resource allocation may be affected in a quite indirect way by the release of purchasing power from application to a particular resource and increasing the demand for some other commodity thereby pulling additional resources into its production.

Mr. MILLS. Now let us ask the same questions concerning built-in flexibility in tax system.

Which of the excluded items of income, which of the deductions, have a bearing on how responsive income-tax revenue is to changes in total personal income?

Mr. HOLLAND. As far as the excluded items go, many of them are of a rather stable sort.

Many of them do not respond with the same volatility that the general flow of incomes responds to changes in economic fortune.

For instance, pension payments, business transfer payments, State and local pension and relief payments, etc., are rather stable, as is the net imputable income from housing.

I think in that connection perhaps the most relevant income source in terms of its effect on the built-in flexibility of the income tax is capital gains, and there the inclusion of only one-half of capital gains tends to lessen the built-in flexibility of the income tax.

The magnitude of capital gains can be overstressed however. It is relatively small in the total picture.

Mr. MILLS. Mr. Holland or Mr. Kahn, you have offered us estimates with respect to the year 1952 of the extent to which we could reduce income tax rates by broadening the tax base to come far more closely with the concept of personal income.

Would you estimate the amount of these reductions for the current year?

Mr. KAHN. If I understand your question correctly, Mr. Chairman, you are asking what would be the comparable increase in tax liabilities for 1955, that resulted in 1951 from my having eliminated the deductions and the exemptions.

Rough estimates that we have indicate that for either 1954 or 1955, the tax liability that would result under the present tax law would be around $30 billion.

That figure would be comparable to the $24 billion that we got in 1951.

Now if we eliminated exemptions and deductions, all I can do, really, is to extrapolate the 1951 relationship and hazard the guess that we would probably add on, roughly, another $30 billion.

It may be slightly less. It is very difficult to say, because a good many distributional questions enter in, that is, much depends on what the average tax rate would be, but I think it would increase tax liabilities to a total of $60 billion.

Mr. HOLLAND. May I add insult to the injury implied by that type of hypothetical calculation, and that is that carrying out the drastic tone of your question—I am implying nothing as to policy—if in addition I might point out, income splitting were removed (we mentioned this and I want to bring it up again) and married persons were by some device or other taxed as single persons are now taxed, then you could add to that $30 billion, three to three and a half billion more.

Mr. WHITE. That is, these estimates also presumably assume that the before-tax income would not be affected by the drastic change in the tax law.

Mr. HOLLAND. These estimates made no correction for the possible increase in the ingenuity of persons in converting income to some nontaxable form.

Mr. WHITE. I was thinking of the economic impact of removing that much purchasing power, if that is what were done, or the economic impact of offsetting that absorption of purchasing power by reduction of rates.

In a sense it is an incompleted model here, and I would want to take the figures with reservation.

Mr. MILLS. I wish you would translate your estimates for 1955 into actual rate reductions.

How much rate reduction would that mean?

I may be a little unfair, because you may not have had time to make those computations.

Mr. KAHN. To begin with, I actually only illustrated for the deductions what the possible rate reductions might have been for 1951, and as I recall, I stated that for 1951 if we were to eliminate the deductions, rates could on the average be reduced by 20 percent all along the line.

Now, I don't think that that percentage would change very much for 1955.

Mr. MILLS. So that in 1955, if we eliminate these provisions of law, the overall reduction in tax rates would perhaps remain the same as estimated for 1951?

Mr. KAHN. That is right.

Now let me make one thing clear once more: The 20-percent reduction that would become possible in tax rates, to which I just referred, was if you eliminate deductions only.

I do not have an estimate at my fingertips as to how much you could reduce rates if exemptions also were eliminated.

I did say that in 1955, we could probably also reduce rates all along the line by about 20 percent because we know one thing, and that is the average rate of tax on the actual tax base has remained practically constant for a good many years.

We have fairly good figures on the tax base; we know how it is distributed, and if we apply a given rate schedule to it (this has been

done particularly by Dr. Pechman), we find that the average rate on taxable income remains fairly constant from year to year, even though the total of taxable income has been rising.

That may sound somewhat paradoxical because we have a progressive rate structure. But it is mainly due to the fact that many new incomes, as total income rises, are added at the bottom of the scale and their weight is so great as to keep the average rate from rising, and it is on that evidence that I would say that the relationship for 1955, as far as reduction of tax rates is concerned, would be pretty much the same as in 1951.

Mr. MILLS. Let me ask you: Have you made any estimates at all for the reasons for low reporting of unincorporated business income?

Mr. HOLLAND. I have made no estimates of the reasons for that, and I should at this time once more point out that these figures, of course, are very imprecise, especially the one you have just asked about, because the national income estimates of the size of this particular source of income and the tax figures are both basically derived from the same source, so that there is some interconnection between them. The entrepreneurial sector estimates are admittedly the weakest of the national income accounts, so they can be held with less confidence than some of the other components.

Mr. MILLS. Have you tried to determine whether the initial estimate of the income in the national income totals might be too high?

Mr. HOLLAND. We have not investigated that figure. That is why we have thrown out at various points in our statement, the words "statistical error."

Mr. MILLS. Do you think the deficiency is attributable to systematic underreporting, or a large number who report nothing?

Mr. HOLLAND. That is hard to say, except that I can translate your question into something that may be inferentially relevant to it, and that is, if by systematic underreporting you mean consistently the same degree of underreporting by income class of taxpayer.

Mr. MILLS. Let's assume that is what I mean.

Mr. HOLLAND. Then the answer is that as far as we can tell from a very rough evidence from the 1948 audit control survey of what was then the Bureau of Internal Revenue, the underreporting is concentrated in the lower income classes, both absolutely and proportionately.

Mr. MILLS. Well, then, is there a possibility that much of the deficiency is attributable, or could be attributable, to just plain inability to deal with complex tax accounting and reporting?

Mr. HOLLAND. I cannot say.

Mr. MILLS. Do you have any ideas at all, on the basis of your study, as to what the Congress might be able to do with respect to this problem?

Mr. HOLLAND. Well, suggestions have been made as regards the other types of income, which seem to be more amenable to control, dividends and interest, in connection with instituting source withholding on such payments; as regards entrepreneurial income, the only suggestion that I can make is to work harder and do better in connection with the auditing of this type of return.

Mr. MILLS. It is an administrative problem, in other words?

Mr. HOLLAND. I think so.

Mr. STRAYER. Could I add a word?

Mr. MILLS. Yes. I was going to address a question to you in a moment.

Mr. STRAYER. I wanted to say that, as I recall from past studies, the Internal Revenue Service has been able to show that for every additional collector or investigator added to their staff, they could pay his salary many times with the additional income discovered. In face of the tremendous increase in workload, there has been nothing like a proportionate increase in staff. I would like to see Congress give them a larger appropriation to collect more net revenue.

Mr. MILLS. Some of the difficulty has been, I think, due to inability to obtain qualified personnel, as well as lack of funds. Members of the Appropriations Committee have so advised me on occasion. That is also an element involved.

Mr. Kahn?

Mr. KAHN. Could I add one thing to what Mr. Holland just mentioned on the possibilities of cutting down on underreporting in certain types of income? It comes to my mind—and this is something that Dr. Atkeson also mentioned this morning—that through the information returns, which I think were abolished in 1954 but which we had before, we did, of course, have the possibility of finding out something about the flow of certain types of income.

At that time we were required to report all payments that exceeded $600 that were made during the year to any one individual, which particularly included rent payments to one's landlord. Now, we don't have good figures on the rental sector, but we have indications that that is another area where underreporting is strong. The $600 information requirement would also apply to payments made to lawyers, doctors, and other independent professions. I don't mean to imply that they are great violators of the tax law, but in any case they fall into the entrepeneurial category, in which enforcement has been the greatest administrative problem.

Mr. MILLS. Professor Strayer, you observe in your paper, on page 345 of the compendium, that the most significant effect of the level of exemptions under the individual income tax is that of determining the size of the tax base. In this connection, Mr. Kahn has pointed out that in 1952, personal exemptions totaled $83.6 billion out of a total adjusted gross income of $240 billion, and total personal income of $271 billion.

In other words, the present personal exemption has a very substantial effect in reducing the tax base. I want to make clear for the record before I proceed further with this question, as I think it is understood in all my questioning, that my questions are to obtain information and do not necessarily reflect my own views.

With that preliminary statement, let us suppose the personal exemption was reduced by, say, $100, and the resulting increase to the income-tax revenues were devoted to income-tax reduction for low-income individuals by, say, splitting the first bracket, with a lower rate, and to reducing the excises which bear heavily on low-income consumers. First, how much additional revenue do you estimate we would obtain from reducing the personal exemption, and next, how much of a rate reduction would this make possible; and third, do you think the resulting tax structure would be more favorable to low-income individuals than the present one?

Mr. STRAYER. This is quite a question. I defer to my colleagues, Mr. Holland and Mr. Kahn, for the estimate as to the additional revenue or rate reduction made possible. I haven't worked with these data and had not anticipated this question, so I hope maybe while I am talking to the other points of the question, they might scratch a couple of notes and bail me out.

There would certainly be some increase in revenue and some rate reduction possible. With regard to whether this would give us a more equitable distribution of tax burden, I think we need to look at two questions: One is average distribution and the answer would depend on the extent of the cut and the actual incidence of the existing excises on this particular group.

This would require some fairly careful estimating, which I haven't been able to do.

Another type of equity, though, is involved, and on this results would seemingly be positive; that is, the equal treatment of equals. Certainly the incidence of excises is commonly supposed to be on the purchaser—tobacco, for example; the cigarette tax is a heavy burden on the smoker, which reduces the income he has available for other purchases. The demand is generally conceded to be quite inelastic, the habit firmly established. If you relieved a substantial part of the tobacco tax, you would be able to distribute the income-tax burden more evenly among people, regardless of their habits, with regard to the use of tobacco.

You could also have an additional gain of being able to adjust your tax to the individual circumstances, particularly the family circumstances, which cannot be done with excises. I hope my friends have come up with some figures.

Mr. MILLS. You do think that the resulting tax structure might be more favorable to low-income individuals if this action were taken?

Mr. STRAYER. I think on an average basis it is hard to determine until we see what these figures indicate, but as far as the equal treatment of equals, we could get someplace. I want to also put into the record, Mr. Chairman, in my answer I take the same position that you do. I think this is a most ambitious sort of idea.

Mr. MILLS. I am throwing out an idea for you to toy with and certainly not force you to commit yourself to in any set pattern.

Mr. HOLLAND. Playing with this idea, I think a rough estimate would be that the $100 decrease in exemptions that you postulated solely for purposes of scholarly discussion amongst us; that decrease in exemptions might involve a loss of revenue of between 2½ and 3 billion dollars.

Mr. MILLS. You mean a gain?

Mr. HOLLAND. Yes—A gain of revenue of between $2½ and $3 billion.

Mr. MILLS. Then if that were used for rate reduction purposes, it might mean how much out of a rate reduction? We could very easily split the first bracket with a lower rate, couldn't we?

Mr. HOLLAND. Certainly.

Mr. MILLS. Could we reduce some excises, in addition, that bear heavily upon low-income consumers?

Mr. KAHN. I think we found that that would be equivalent to a 2½ lower percentage point reduction for all brackets.

Mr. MILLS. That would be across the board?

Mr. KAHN. Yes.

Mr. HOLLAND. Lower all bracket rates by 2½ percentage points.

Mr. MILLS. We might very well be able to split the first bracket, say with a lower rate of 10 percent, and have money left over to eliminate many of the excises that bear heavily upon the low-income consumers, if we have as much as $3 billion in this $100 exemption.

Mr. HOLLAND. I am not sure of that.

Mr. STRAYER. As I recall, Mr. Chairman, some older figures indicate that about—or used to indicate that about 70 percent of the total tax base was in the first bracket, which would make me doubt a little bit. Then you would have to watch where you split it.

Mr. MILLS. I just throw this out. Of course, it is not likely to become law. I throw it out because there are those who contend that the base itself—we are talking now about the base for tax structure—should be very broad; that everyone should be made aware directly of taxation, rather than to use the device of indirect excises, paid, maybe, at manufacturing levels, and therefore hidden, and other types of taxes; that we should start with a very broad base at the bottom and then work our rate structure in such a manner as to do what we want to do with low-income, middle-income, or upper-income brackets. It is, I guess, possible that you could work out such a structure, even with a very broad base, which means very low exemption, and still not do violence to the needs and necessities of low-income individuals, but whether we would want to do it would be a matter of policy. I have mentioned it solely because there are those who have that viewpoint, and I want it in the record somewhere as to the possible effect upon low-income people.

Professor White, you have stated that the purpose of developing and using a logically tight definition of income in personal taxation is to provide a short cut to fairness. Of course, we recognize that fairness in the tax structure is the most important requirement, but would you agree that, as you put it, a logically tight definition of income is equally important in making sure that the tax does not have bad effects on the use of our economic resources?

Mr. WHITE. I would say that is a secondary consideration. The tight definition of income makes clear what is necessary in order to achieve equity, but that to tax on a logically tight definition of income does not necessarily mean that the economy will advance in the economic directions that you may want it to go insofar as tax policy can contribute to it. Deviations from equity may be justified by the desirability of economic effects.

Mr. MILLS. But it will have effect upon the use of economic resources?

Mr. WHITE. Any tax has an effect on economic resources and whether it is based upon a logically tight definition or not.

Mr. MILLS. With a tight definition, it has less bad effect; is that right?

Mr. WHITE. I think, without specifying precisely what the economic goals are, it would be hard to say whether it is a good or bad effect economically.

Mr. MILLS. Professor White, could you suggest a general rule which could be followed to determine what deductions should be allowed in

the income tax and what deductions should be disallowed if we wanted to have a logically tight definition of income?

Mr. WHITE. A general rule. Well, I think the general rule that I tried to articulate was its consistency with a defined concept of income. That is the general rule, and what I tried to do was to show some of the implications of the application of this general rule for the major categories of personal deductions which exist at the present time. Upon a careful analysis, it turns out that some of the deductions at least are questionable in their relationship to income—which is the test of whether or not a particular deduction or exemption should be given. This is the essence of equity. You can deviate from it, of course, to serve other objectives of policy which might be considered to override equity.

Mr. MILLS. Let me ask this question of the panel: Have you thought in terms of the advisability or inadvisability of translating exemptions into tax credits, rather than the exemptions, say, of so many dollars of income from taxable income?

If you have, are there any advantages from the point of view of economic growth and stability in such a change? Do you understand what I mean?

Mr. KAHN. If I may speak to that point, the first thing that comes to my mind, since you mentioned economic stability, is that as the exemption stands now, namely, as a subtraction from taxable income, its tax value varies with the top bracket into which the taxpayer falls. This means that its tax-reducing importance is greater when income is high and less when incomes are low, and so if you consider it purely from the point of view of its effect on the instability of the tax, or stabilizing effect on the economy, I should think that the present type of exemption would be less effective.

Now, again, I don't know how important that is quantitatively, but I just wanted to make that point.

Mr. MILLS. The reason I asked the question, Mr. Kahn, is this: You get more of your overall national income in your tax structure, to begin with, by the use of a credit device versus the exemption device, do you not?

The credit device goes against the total tax.

Mr. KAHN. That is right. In some States, I may add, they have that credit device.

Mr. MILLS. Would it then be possible to have greater built-in flexibility in your tax structure through the use of a credit device versus the exemption device, laying aside all questions of equity, and so forth?

Mr. WHITE. You are assuming that the revenue loss would be the same under either case?

Mr. MILLS. Yes. For example if you give the credit for tax purposes the same effect that the exemption now has in the first bracket, I am not thinking, however, of whether it loses, remains the same, or gains revenue. I am thinking of this question, how we can have greater built-in flexibility—we are being told by panelists that that is a desirable goal and we are also being told by panelists that one way to obtain greater built-in flexibility is to have more of this adjusted gross income figure in the tax base.

I am raising the question, then, if you could have greater built-in flexibility through the device of a tax credit, in lieu of your exemp-

tion. Mr. Ture wants to address a question to you at this point, Mr. Kahn.

Mr. TURE. Mr. Kahn, you pointed out that the value of the exemption, and therefore the value of exemptions in the aggregate, increases as income increases, and falls as income falls. I think what Mr. Mills is suggesting on this point is that if you substitute a tax credit which will not vary directly with the level of income, though it will not in itself necessarily be a stabilizer, it will not certainly be a destabilizer.

Mr. KAHN. That is right. Since the tax value of the exemption is greater in times of high income than in times of low income, compared to a tax credit, the income exemption would be relatively destabilizing; that is right.

Mr. MILLS. Professor Strayer?

Mr. STRAYER. We could add one offset to that, though; that if you kept existing rate structures, the use of the tax deduction would make the existing structure somewhat more progressive. I think we are dealing with very small magnitudes, in any event, but to complete the record, it would have this other offsetting effect.

Mr. MILLS. As I understand you, and I think I am in accord with your statement, if you translate the value of the exemption into a credit equal to the tax in the first bracket, you do thereby increase progression in the income-tax structure, that is true. I would agree with you completely on that.

Mr. STRAYER. And a somewhat more progressive structure is apt to be somewhat more responsive to changes in adjusted gross income.

Mr. MILLS. I was just coming to that. We have been told that that is another way to have built-in flexibility in the tax structure.

Mr. STRAYER. Of course, we have got to qualify that too by saying where does the change in adjusted gross income occur?

Mr. MILLS. At the present time we are not talking about something that may be as farfetched as my first proposition of reducing the personal exemption, which of course, we don't expect to see enacted any time soon, but there has been thinking in the Congress with respect to the question of whether it would be better to have a tax credit than to have our present system of exemptions, and it is for that reason, because of that thinking that I want it in the record at this point—your evaluation of it from the viewpoint of flexibility and otherwise.

Now a number of the panelists, including Professor White, as I remember your paper, have criticized the deduction approach to charitable contributions as opposed to a credit approach on the grounds that the deduction gives greater advantage to high income groups who presumably influence the policies of the donee. Have I properly interpreted your paper in that respect?

Mr. WHITE. Yes. That certainly is an aspect of it.

Mr. MILLS. Does the panel consider this change—the suggestions which Professor White and others have made—important at the present time or not? Is it important; worthy of immediate consideration?

Mr. STRAYER. I think you would find that it would be deterrent to some of the large gifts given to educational and religious institutions, as the amount of the gift would have to be substantially greater or the net cost to the taxpayer would be greater to give the same sum.

Mr. MILLS. How high would you make the standard deduction for this purpose?

Mr. STRAYER. I haven't thought about it in specific terms but there would be some point where the very wealthy man would find this a deterrent.

Mr. MILLS. Professor White, as I remember, you also criticized the treatment of homeowners in connection with failure to include imputed rent and in connection with that allowing deductions for mortgage, interest, and taxes. Would the other members of the panel desire to comment along that line, on the desirability of providing a net encouragement to homeowners here through tax policy? Professor White, I am not excluding you in this, either, if you want to comment on that.

Mr. WHITE. That is, the general use of tax policy to encourage home ownership. I have no objection.

Mr. MILLS. Should it be done?

Mr. WHITE. At the outset for using tax policy for this purpose. I don't think that this way, which is a concealed, nonexplicit technique, for providing subsidy is the correct way to do it if the subsidy is to be given. I think perhaps what I would want to do is to examine alternative approaches to the problem of encouraging home ownership before attempting to use tax policy for that purpose.

Mr. MILLS. You were not endeavoring, then, to imply that encouragement through tax policy should be given to home ownership in your paper?

Mr. WHITE. No. I would say that I think that other alternative approaches should be examined first. I wouldn't want to rule out the use of tax policy, but when it is utilized, I think it should be made explicit, not implicit in the form that it is now.

Mr. MILLS. Professor Strayer?

Mr. STRAYER. I would tentatively object, and favor the taxation of the imputed income of homeowners, if this is at all possible. I object on the ground that there are many individuals who find it impossible or unwise to own their own home. Why should they be discriminated against in the process of providing the favor for those that do find it feasible and desirable to own their own homes?

I think on the general ground of equity that I would be quite distressed to see this made a matter of policy and am in fact on record wishing, if we can find the practical means, of taxing computed income on homeowners.

Mr. HOLLAND. There is another way of correcting this discrimination (I think it was a method that we used in our Civil War income tax), and that is to make special allowances for rental payments, but that would not be progress as it is now defined.

Mr. MILLS. Senator Douglas will inquire.

Senator DOUGLAS. The first question I have is directed primarily to Mr. Holland. It is a question involving whether or not it would be wise to have a withholding tax on dividends and interest payments.

I am struck with the fact that in the case of wages and salaries, where there is a withholding tax, the percentage of total wages and salaries which is reported for taxable purposes runs as high as 95 percent, with only a 5-percent evasion, or failure to report; but as you point out in the case of dividends, there is a 13-percent evasion or failure to report, and of course dividends are not withheld at the source.

I assume that if there were witholding at the source it would be fair to say about the same percentage would not be reported as in the case of wages and salaries. Is that fair—that 5 percent would not be reported instead of 13 percent?

Mr. HOLLAND. I am not sure whether that may be too liberal. I think that may be too liberal an estimate of the amount that would not be reported.

Senator DOUGLAS. You think there would be more than 95 percent reported?

Mr. HOLLAND. Yes.

Senator DOUGLAS. I am trying to estimate, in a conservative way, what the probable increase in revenues would be?

Mr. HOLLAND. I think that is a conservative figure.

Senator DOUGLAS. At least, it would not be less than 95 percent reported.

Mr. HOLLAND. Probably not less. If I may interject here in 1941 the figures indicate that we did have abount 94 or 95 percent reporting of dividends.

Senator DOUGLAS. In the Economic Indicators for November 1955 it looks as though the dividend payments for this year will be just under $11 billion, or roughly $10.4 billions, and we would thus expect to recover about 8 percent of that, or a little under $900 million in taxable income.

Now, have you an estimate as to the percentage of the personal income tax at which dividend receivers pay income tax—the average percentage?

Mr. HOLLAND. I have no such estimate, but with the lightning speed that we have been working in calculations this afternoon, we can put some values on it. It certainly is less than the overall average of 25 percent.

Senator DOUGLAS. You think it is less?

Mr. HOLLAND. Excuse me. It certainly is higher. Higher than the overall average of 25 percent. It would probably be less than 40.

Senator DOUGLAS. If it were 25 percent we would gain about 225 millions in tax revenues from the 900 million not reported.

Mr. HOLLAND. I think a fair estimate, recognizing all the possible errors in it, it would be about 300 million to 350 million.

Senator DOUGLAS. On dividends. Those are the rough calculations I have also made. They were very rough, I can assure you.

Mr. HOLLAND. Mine were, too.

Senator DOUGLAS. On the question of interest payments about which I know far less, I was struck with your statement that only 39 percent of interest received by individuals was reported, and that there was either an evasion or a nonreporting factor of 61 percent.

At the bottom of page 2, and the top of page 3 of your summary, you go into some of the reasons for that.

I wondered if you would develop that for us.

Mr. HOLLAND. Well, one additional factor not mentioned there, because we did take it out of our calculations, was mentioned this morning, the interest-saving bonds. Our calculations assume that people put off forever that dreadful day of accounting for it and that they do not report it currently on an accrual basis. Had we included it, the percentage would have been greater than 61.

Senator DOUGLAS. E–type bonds.

Mr. HOLLAND. Yes.

Senator DOUGLAS. Have you an estimate on that?

Have you an estimate as to how much that is?

Mr. HOLLAND. I have, but we did not include that in our figures at all, so that that source is not in there.

I can only elaborate a little on what we have mentioned here, that much of interest is of an almost informal sort, for example, savings bank interest just accumulates and no formal records or statements come to the taxpayer. It is easy to forget it.

Senator DOUGLAS. Would that be true of building and loan deposits?

Mr. HOLLAND. I could not say.

Senator DOUGLAS. Have you an estimate as to how much the credits for interest on savings accounts would come to?

Mr. HOLLAND. I have not.

Senator DOUGLAS. What we are trying to get at is this: If we had withholding at the source, by how much would taxable income and tax revenues, increase?

Mr. HOLLAND. I cannot answer that question even in the cavalier spirit of estimates that we have made this afternoon. I would have to think about that.

Senator DOUGLAS. Have you allowed for tax-exempt bonds? They are not included in three and a half billion.

Mr. HOLLAND. No, sir.

Senator DOUGLAS. This seems to be a very large figure, three and a half billion not reported.

If the tax was 25 percent even, that would be $900 million in taxes, and the two together would be about $1.25 billion.

Mr. HOLLAND. Yes.

Senator DOUGLAS. $1.2 billion, probably.

Have you given any thought to the question as to why there should be a withholding tax on wages and salaries but not a withholding tax on dividends and interest?

Mr. HOLLAND. I have not. It is my general impression that that is an administrative question, and has been viewed in that light. I am not an expert on administration and would not care to suggest offhand that other people take up burdens that in the past have seemed to be too heavy to carry.

Senator DOUGLAS. There has been a verbal justification for it, on the ground that there are a lot of interest recipients whose total income is less than $600 for a single person and $1,200 for a married person, but I wonder if there is any greater percentage of cases of low-income receivers among those who receive interest and dividends than among those who receive salaries.

Is it characteristic of the community that the recipients of interests are in lower-income groups than those who receive wages?

Mr. HOLLAND. The distribution of interest may be slightly more concentrated than the distribution of wages and salaries; but not pronouncedly so.

Mr. DOUGLAS. At least, it is not less concentrated.

Mr. HOLLAND. Pardon?

Senator DOUGLAS. It is not less concentrated, or, it is not more difused than wages.

Mr. HOLLAND. I do not think so.

Senator DOUGLAS. So that if there is an administrative objection to withholding at the source for interest, that would be at least an equal objection to withholding at the source for wages, would it not?

Mr. HOLLAND. It follows from the logic of your statement.

Senator DOUGLAS. That is what I am interested in.

Mr. HOLLAND. I can only answer to logic, not as to administrative difficulties.

Senator DOUGLAS. Similarly, if we are to withhold income taxes on wages, why not withhold taxes on interest?

Mr. Kahn?

Mr. KAHN. Senator, I don't want to argue against withholding, but I would just like to make one point in connection with the matter of distribution of interest.

Senator DOUGLAS. Would you speak into the microphone?

Mr. KAHN. I just want to say that even if interest were less equally distributed or much less equally distributed than wages——

Senator DOUGLAS. Which presumably it is.

Mr. KAHN. Well, let us say it is somewhat less evenly distributed.

Senator DOUGLAS. After all, I don't think there is any use in shadowboxing around that point. A larger percentage of interest certainly goes to those in the upper income groups than is true in the case of wages and salaries. That is obvious. I don't think there is any question about it.

Mr. KAHN. Let me mention one thin——

Senator DOUGLAS. You don't deny that do you?

Mr. KAHN. I don't know.

Senator DOUGLAS. As I remember, the studies of your own Bureau indicated that, at least in previous years, when I was keeping up with the studies. I am not trying to scold you but I am just amazed that you don't come forward and assert it instead of shadowboxing.

Mr. KAHN. A great deal of interest is received by small savers.

Senator DOUGLAS. That is true, It is true of absolute amounts, but I am speaking of the relative distribution.

Mr. KAHN. There are figures but I don't have them clearly in mind. I did not want to argue the question of whether it is very much less equally distributed, or not.

The point that I wanted to bring out though, is that whatever the relative distribution, the interest component of income is so much smaller than that of wages and salaries. A great many people receive very small amounts of interest, so that that particular factor, of course, would militate against withholding on very small amounts of interest, even where the interest may be distributed much more unequally than wages.

Senator DOUGLAS. We might as well settle this with the figures. If we do not have them from the National Bureau, I do have a table here which was compiled from the Statistics of Income for 1951.

If we take all taxable returns under $1,000, they received only seven-tenths of 1 percent of all interest paid out. They received six-tenths of 1 percent of the salaries and wages. Now, take the upper income groups. That is perhaps a better measure than the lower group.

Take the group from $20,000 to $30,000. They received over 1.4 percent of salaries and wages, but 8 percent of interest; the group from $30,000 to $50,000, 1.2 percent of salaries and wages, but 7.4 percent of interest; the group from $50,000 to $200,000, 0.8 of 1 percent of salaries and wages, and 5.7 percent of interest.

The group from $100,000 and over received 0.4 of 1 percent of wages and salaries, but 4.1 percent of interest, or taking these last groups with incomes above $20,000, they had 3.8 percent of salaries and wages, but 25 percent of interest receipts, so this, I think, makes it clear that the interest receipts go to the upper income groups much more than wages and salaries do.

I thought that was obvious and didn't need statistical proof, but here it is, and we will let you look at our fact book afterward and check the figures.

Now, if that is true, and we believe it is true—I don't see how the truth can be denied—what justification is there for withholding taxes on wages, but not withholding taxes on interest? If it is administrative difficulties, administrative difficulties would be far greater in the case of wages and salaries than in the case of interest, for it would deal with more people. There are married people who don't have a $1,200 income and yet have a refund of personal income taxes.

Mr. MILLS. May I interject at this point?

Senator DOUGLAS. Yes, sir.

Mr. MILLS. You are referring to reported interest in that table.

Senator DOUGLAS. Yes.

Mr. MILLS. One of the virtues of a withholding system would be to get interest that is not reported.

Now, I think if you are for withholding on interest, you would want some idea of where the avoidance lies. Is it in the upper brackets, in the lower brackets, or in the middle brackets, or is it being received by institutions and individuals not subject to tax.

Mr. HOLLAND. Let me say two things about that, please.

First, the institutions not subject to tax have been taken into account in the figures that I presented.

Second, again from very rough figures it seems that the mass of interest underreporting is in the lower income brackets. For this purpose, lower has to be defined very broadly.

Senator DOUGLAS. Have you any sample studies of that or is this an assumption?

Mr. HOLLAND. It is not an assumption. The studies themselves were not made for the purposes of statistical convenience for this type of work, but rather were made for the purpose of convenience in tax administration.

I am referring to the 1948 Audit-Control Survey, where the figures are expressed for very broad income ranges and in terms of tax change upon audit rather than as income amounts themselves. The calculation of the amount of income change that would lead to the tax change, is difficult, but from those figures the inference can be drawn that underreporting appears concentrated in the lower income classes.

Senator DOUGLAS. Avoidance?

Mr. HOLLAND. I said underreporting.

Senator DOUGLAS. Well, wouldn't you say that if they owed the tax they should pay it even though they are in the lower income bracket?

Mr. HOLLAND. I would answer "Yes" to that.

Senator DOUGLAS. Thank you.

Well, do you see any reason why therefore we should not have a withholding at the source?

It certainly would not be as big a job as withholding for wages and salaries.

Mr. HOLLAND. Once again, I cannot speak for the administrative difficulties connected with this problem, but in the spirit of logic and equity, the answer to your question is that there should be withholding on dividends and interest.

Senator DOUGLAS. Thank you.

Just one question I want to address to Mr. Strayer.

It is this question. If there is a net reduction in tax rates, should it be a reduction in Federal excise taxes, or in Federal income taxes? Our figures for 1955 are that the total excise collections amounted to $9.2 billions, and of this about 47 percent came from liquor and tobacco.

Are you proposing to decrease the liquor and tobacco taxes in order to stimulate the consumption of liquor and tobacco, or is this a prejudice on the part of tobacco smokers?

Mr. STRAYER. As a good tobacco user I obviously have self-interest in my mind, but I am not anxious to increase consumption.

I am anxious to remove a discriminatory burden upon someone who is the victim of such evil habits.

I do not favor the selection of taxpaying capacity on the basis of your personal consumption habits.

I would certainly be hesitant to say that we should remove the tax on liquor. I think it may serve a useful purpose.

Senator DOUGLAS. You do favor removal of the tobacco tax?

Mr. STRAYER. I see no useful purpose served by the tobacco tax.

Mr. WHITE. The point that Mr. Strayer made before—and I think is accurate perhaps in the case of tobacco and also in the case of liquor within at least a wide range—is that the demand for these commodities is very inelastic.

I have no a priori reasons for saying we should not use the tax system perhaps to discourage certain kinds of consumption but if it is true that the demand is very inelastic then the tax is not discouraging consumption.

It is used as a revenue raiser. By lowering the tax on tobacco and liquor it has sometimes been said you may increase the consumption of milk and that may be altogether desirable from a social point of view.

Senator DOUGLAS. Of course, it could be argued that if you make beer and hard liquors more expensive, people will turn to milk as a substitute, that they are competing liquids, and not——

Mr. WHITE. That is right. That is the point at issue here and it is an empirical question to be settled. The demand for tobacco, I understand is fairly inelastic within the price range, and that is another way of saying that the substitution effect is very low.

Senator DOUGLAS. I think that is true.

The tax on all automobiles is about 11 percent of total excises and gasoline, 10 percent; you would cut those taxes, Mr. Strayer?

Mr. STRAYER. I think we have a very special problem on auto transportation, and I would want to look at this whole problem of highway construction and its financing.

I would hesitate to talk about these paricular cases unless I could determine some way of assessing the cost which the auto user is now imposing. I think we should look at this fresh and come up with some way of relating uses of the highways to the highway expenditures, so I would tend to want to deal with this quite separately this whole highway field.

Senator DOUGLAS. We are being asked to put through a much larger highway program, which will require a larger volume of annual financing, if not now, ultimately.

However, one may differ on where this burden should be borne, certainly a very large share of the burden, to my mind, an extremely large share of the burden, should be borne by those who use the highways.

Mr. STRAYER. I agree with you.

Senator DOUGLAS. Therefore what we may find is not a deduction in the gasoline tax but an increase in the gasoline tax.

Mr. STRAYER. That is very possible.

Senator DOUGLAS. Now we have accounted for almost 70 percent of total excise taxes.

Mr. STRAYER. I am still keeping tobacco on the list.

Senator DOUGLAS. I think the WCTU would disagree with you sharply on this point.

Now what about the general admissions tax, on movies and theaters? Would you reduce that?

Mr. STRAYER. I think it would be preferable to reduce some of these taxes which again discriminate on a person according to his taste, rather than his income.

Senator DOUGLAS. What about the cabaret tax?

I received 4,600 letters during the last week from members of the musicians union who wished to have the 20-percent cabaret tax removed, and apparently the definition of a cabaret is a place which has live music.

Now I have been holding off answering these letters.

I don't know whether I should address this question to a professor or not, but he is from near New York and perhaps he can qualify on this question.

How shall I answer the demand to reduce the cabaret tax, Mr. Strayer?

Mr. STRAYER. Again I see no reason why we should interpose our judgment as to the way in which a person should spend his money. I am not a frequenter of the cabarets of New York but I see no reason why I should impose a penalty on someone who has such taste.

Senator DOUGLAS. How much reduction in the excise taxes do you think we should carry through?

Mr. STRAYER. I would hope that you could cut almost all of them, except for the highway, which I think I would deal with quite separately. Eventually I would like to see these taxes eliminated, except to the highway users. On liquor we also have a special problem.

On this I don't have enough information to know whether or not there is any merit in the claim that we may have pushed this tax too far in terms of its effect on bootlegging and illicit traffic.

Senator DOUGLAS. It would take a great deal of research to establish that fact.

Mr. STRAYER. I have no information. I am familiar with the argument but I think the tobacco and the transportation and communications taxes are particularly bad, and haphazard in their incidence.

Mr. MILLS. Professor Strayer, are you saying in effect that excise taxes generally are more of a deterrent to economic growth than taxes based upon ability to pay?

Mr. STRAYER. I would say they are more a deterrent to the use of the free market to determine the character of growth. Obviously we do not lack growth at the present time, but we are distorting this pattern of growth to some extent by the selective system of excises that has grown up. I would also say we distort the pattern of geographic development, particularly by such a tax as the transportation tax.

Mr. MILLS. If you found in some specific instances that the excise tax was regressive and was actually deterring growth, you would think then from the viewpoint of economics and the best long-run interests of the economy as a whole that that tax should be eliminated?

Mr. STRAYER. I certainly believe that this is something which should be eliminated now, to avoid any further distortion.

Senator DOUGLAS. You believe that the 12½ percent, or almost $1.2 billion which we get from the excise tax on communications and transportation is particularly heavy and should be greatly reduced?

Mr. STRAYER. Yes. I can add that I was a party to some discussions that occurred in the Treasury during the war when some of these taxes were put on.

I felt uncomfortable at that time when we were given an assignment to raise a certain amount from additional excises, but with the war on we swallowed things that we would not and should not swallow in more favorable circumstances.

Senator DOUGLAS. The point is that these were started during the war and then continued by inertia after the war?

Mr. STRAYER. That is right.

Senator DOUGLAS. I think I have taken up enough time.

Mr. MILLS. Mr. Ture desires to query the panel.

Mr. TURE. I would like to direct your attention again to the question of the provision in the law of deductions for interest payments on residential properties.

We assume that the deductions for these items are regressive so far as their distribution by income classes is concerned.

Obviously they are more valuable taxwise the greater the income or, equivalently, the greater the value of the property, but apart from the distributional question, isn't it fair to say that in essence these deductions are equivalent to a reduction in the interest rate which the homeowner-borrower must pay on his mortgage?

Is that a correct inference to draw, do you think?

Mr. WHITE. From his point of view, yes. I assume a rational borrower, in calculating how much interest payments will really cost him, will take account of the deductibility from his tax. But that is no defense for using this technique for implicitly reducing interest cost.

Mr. TURE. Of course, I was not suggesting either defense or indictment. I am simply trying to suggest that these deductions are, in fact, approximately equivalent to an adjustment in the interest terms

upon which the homeowner borrows the money to finance the acquisition of the home.

Mr. WHITE. That is, aside from the distributional aspects, sir?

Mr. TURE. Yes.

Obviously the reduction in interest rates will be greater the more valuable the property, and the higher the marginal tax rate to which the home purchaser is subject.

It was pointed out yesterday in the course of our session that one of the considerations with respect to the use of monetary policy for stability and long-run growth is the adjustment of interest rates to the real time preferences that prevail in the economy, so that if, through the tax system, we provide a measure which in effect reduces interest rates with respect to one type of economic activity, this is going to represent a distorting influence in terms of overall resource use in the economy; will it not?

In other words, we are saying that regardless of the system of time preferences that prevails throughout the economy, in at least one particular area we are going to make an exception to that.

We are going to say that however that time preference would be registered in the market for this particular resource we are going to negate it to some extent.

We will say that time preference in fact is lower.

Mr. WHITE. That is right.

Mr. TURE. Therefore, all other things being equal, we may presume there will be some redirection of resource use.

Mr. WHITE. That is right.

Mr. TRUE. What this boils down to, then, is that we are telling taxpayers generally that we prefer them, insofar as they are determining the pattern of their consumption outlays, to buy homes, rather than other types of consumer items.

Mr. WHITE. There is imposed income that is tax free on other types of consumer durables as well, but, except for that, it is true that under the present tax laws you give encouragement to an individual to become a homeowner rather than a tenant.

Mr. TURE. Well——

Mr. WHITE. If this is the purpose of policy, I would simply advocate that there are fairer and more efficient ways of accomplishing this result.

Mr. TURE. The question was raised this morning by the chairman of the subcommittee and directed to all the panelists, whether in terms of balanced economic growth it is preferable to have a broad set of goals and a tax policy that operates with broad changes to achieve these goals, or to use a system with highly pinpointed special types of tax provisions to encourage the growth of this type of activity or that type of activity. I think that your answer reinforces very substantially the conclusion that was reached by the panel this morning, certainly as to the overall purpose.

Mr. WHITE. Yes; I think it does.

Mr. MILLS. If there are no further statements by members of the panel, or no further questions by members of the subcommittee, the subsommittee will adjourn until 10 o'clock Monday morning.

(Whereupon, at 3:55 p. m., the subcommittee was adjourned, to reconvene at 10 a. m., Monday, December 12, 1955.)

FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

MONDAY, DECEMBER 12, 1955

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON TAX POLICY OF THE
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The subcommittee met at 10 a. m., the honorable Wilbur D. Mills, chairman of the subcommittee, presiding.

Present: Senators Paul H. Douglas and Barry Goldwater, and Representative Thomas B. Curtis.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The subcommittee will come to order.

This morning's session of the Subcommittee on Tax Policy will be devoted to discussion on the economics of capital gains taxation.

As was announced last week, our procedure is to hear from the panelists in the order in which their papers appear in the compendium Federal Tax Policy for Economic Growth and Stability. At the start of each of these sessions, panelists will be given 5 minutes each to summarize their papers. We will hear from all panelists without interruption. The 5-minute rule will be adhered to. Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session. I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee's questions.

Our first panelist this morning is Mr. Jonathan Brown, director of research, New York Stock Exchange.

Mr. Brown, you are recognized for 5 minutes.

Mr. BROWN. Mr. Chairman and members of the subcommittee, my name is Jonathan Brown. I live in Darien, Conn.

The locked-in problem, as it relates to the economics of capital-gains taxation, is vitally important today because it both inhibits economic stability and retards economic growth. These are two basic problem areas toward which these tax studies have been directed.

The term "locked-in" customarily refers to the immobilization of capital—a hobbling of desirable capital transfers—due to the capital-gains tax rate and holding-period provisions of the Federal tax laws.

Though the contribution of present capital-gains tax provisions to economic instability is itself a serious enough condemnation to warrant substantial revision, the potential adverse effect on our future economic growth is even more critical.

This is because our future prosperity is so directly dependent on capital investment: and the capital-gains tax provisions have such a direct impact on the mobility and alocation of our capital resources.

A widely accepted goal for economic growth is a gross national product of $535 billion by 1965, as projected in October 1954 by the staff of the Joint Committee on the Economic Report. This goal would mean an increase in the physical output of goods and services by 39 percent above present record levels and an average per family income of $8,600 by 1965 (in terms of 1955 prices).

But to achieve this goal, domestic business expenditures for plant and equipment alone must increase to about $60 billion in 1965 according to the staff report, compared to a level of about $39 billion now estimated for 1955. This means an increase of over 50 percent and aggregate capital investment in the decade ahead exceeding $500 billion.

One of our greatest economic problems will be how to soundly finance this tremendous sum. Today's level of annual personal savings—barely $16 billion—is not able to provide proper financing for today's levels of capital formation, let alone a future requiring 50 percent more. We are relying too heavily on debt financing. This is partly because over half of personal savings are institutionalized, and by their very nature are not available to supply large amount of equity funds.

Moreover, to help meet the equity capital gap—estimated at 3 to 5 billion dollars per year in new stock issues alone—we need millions of new shareowners. Mr. Philip Reed, chairman of the General Electric Co., just the other day called for 40 to 50 million share owners in place of the 7½ million we have now.

We must have greater tax incentives for equity investment in order to attract these millions of new share owners, compared to the relatively few hundred thousand each year we are able to attract currently.

There is probably as much as $200 billion of unrealized appreciation now "locked-in" equity securities and other capital assets. This is a tremendous potential for capital formation. Today, these funds are immobilized by the present holding period and rate provisions of the capital gains tax law.

Much of this wealth is in stock which has increased substantially in price over the last 5 to 10 years. For an investor whose stock has doubled in price, the capital gains tax is—depending on the income bracket of the seller—a transfer tax ranging from a minimum of 5 percent to a maximum of 12½ percent on the entire market value of the stock being sold. I submit that such a transfer tax either completely immobilizes, or, if incurred, excessively erodes our reservoirs of capital wealth.

Many suggestions have been made for solving this "locked-in" problem. The most meaningful solution would be complete elimination or at least a substantial reduction in the capital-gains tax rates. Another solution which has been increasingly discussed in recent years is an investment "rollover" provision, which would apply to capital assets the principle of tax-free exchanges now prevalent in the law for personal residences and exchanges in kind.

Another suggestion which warrants consideration is to allow a credit against the estate tax for capital gains taxes paid by deceased share owners within some limited period of time before death—perhaps 5 years—or perhaps for all investors over age 65.

The "locked-in" problem today is real, it is timely, and it is highly significant in any consideration of better ways to achieve greater economic stability and sounder economic growth. Its solution is a key to assuring ample equity funds for future capital investment and a stronger financial foundation for our country's continuing economic development.

Mr. MILLS. Our next panelist is Mr. Walter W. Heller, professor of economics, University of Minnesota.

Professor Heller, you are recognized for 5 minutes.

Mr. HELLER. Mr. Chairman and members of the subcommittee, I want to address myself to two main questions, how serious is the lock-in effect really and, second, where does it fit into the scheme of things in determining how we should treat capital gains for tax purposes.

1. To what extent does the capital gains tax lock investors in appreciated investments? Apart from postponements of sales to take advantage of the sharp drop in rates at the end of 6 months, the severity of the lock-in effect has been seriously overrated.

(*a*) Many security holdings fall entirely outside the sphere of influence of the capital gains tax (that is, the holdings of colleges, pension funds, and so forth, and stocks held for corporate control purposes), and many transactions take place irrespective of tax (that is, called stocks and sales to meet emergency cash needs).

(*b*) The capital gains barrier is low relative to dynamic market opportunities. Even with a 50-percent gain on his present holding, the potential seller subject to a 25-percent ceiling rate can (1) improve his income position by any switch to another stock promising a yield increase of one-half of 1 percent or more; (2) improve his capital position by any switch promising a differential capital gain of 10 percent or more; or (3) "shake out" the gains tax by selling and then buying back at any price 8½ percent or more below his selling price. Moreover, nearly two-thirds of all long-term gains are taxed at less than the 25-percent ceiling rate. The overall effective rate on capital gains is just over 13 percent. Today's markets present myriad opportunities to cross these modest tax threshholds. Stock turnover is in fact running at its highest rates in 25 years.

(*c*) For confirmed profit takers, the point of maximum gain is in no way affected by the long-term-gains tax. Buying at the bottom and selling at the top is still the best formula, tax or no tax.

(*d*) These conclusions gain support from the findings of the Harvard Business School tax study; only 6 percent of the 746 "active investors" interviewed reported that the long-term-gains tax affected the timing of their investment transactions.

2. The lock-in effect that remains after screening out the security holdings and transactions that are more or less immune to the capital gains tax is charged with (*a*) accentuating the ups and downs of the stock market and (*b*) interfering with mobility of investments.

(*a*) In particular, it is alleged that lowering the gains tax would help hold a bull market in check by unlocking the holdings of many sellers, thereby increasing market supply. But this ignores three vital facts: (1) Most sellers are also buyers, that is, supply creates its own demand; (2) especially in a bull market, the gains tax drives a sizable wedge between the amounts realized on sales and the amounts that flow back into the market, that is, lowering the tax would release

additional funds to reenter the market on the demand side; (3) in the face of stiff tax rates on ordinary income, the preferential rates on capital gains already act as a powerful magnet that pulls investible funds into the stock market, that is, if the gains tax were lowered, the lock-in effect might well give way to a flock-in effect which would push market prices even higher.

(*b*) Contrary to the charge that the capital gains tax inhibits transfers of resources from old and conservative to new and venturesome undertakings, the Harvard study concluded that the tax preference causes venturesome investors "to shift funds out of relatively conservative investments, offering little or no opportunity for capital appreciation, and into more venturesome types of investment such as relatively speculative marketable common stocks, closely held companies, new ventures, real estate, and oil properties."

(*c*) Insofar as the gains tax does interfere with mobility, the real culprit may well be the option of tax-free transfers of appreciated assets by death or gift. If the investor knew there would surely be a day of reckoning on his unrealized gains, no matter what the form of the transfer, he would more actively press his search for improved investment opportunities.

3. On close diagnosis, then, we find not only that the lock-in effect and its harmful economic consequences have been overstated, but also that the indicated "remedy of choice" is to close the escape hatches marked "tax-free transfers by death and gift" rather than to lower the gains-tax rates. Even more important, we find that we cannot sensibly resolve the capital-gains issue within the narrow confines of the lock-in controversy.

(*a*) We have to broaden our perspective to take into account other economic effects of the capital-gains tax, especially its broad impact on the magnitude and patterns of investment. If there is such a thing as too much investment and if part of the investment that takes shelter under the captal-gains umbrella is of questionable value—and I believe both points can be demonstrated—we should be more concerned about narrowing rather than widening the gap between the tax on gains and the tax on ordinary income.

(*b*) But no tax issue, least of all capital-gains issue, can be resolved on economic grounds alone. To get a balanced decision, we have to bring equity considerations into the picture. One finds little in the generally accepted standards of fairness in taxation that supports, and much that militates against, the case for lighter taxes on capital gains (though these standards do support more liberal treatment of losses). (1) Granting that the investor feels put upon when the gains tax snips out a piece of his capital, we cannot accept his sense of injury as decisive in defining equity in capital-gains taxation. From the standpoint of the vast majority of taxpayers who have little or no access to this form of enrichment, a capital gain must look like a very capable form of taxpaying ability indeed.

(2) Even where gains originate in inflation—rather than the growth in earning power and the drop in capitalization ratios which account for most of our current market boom—the gains are not illusory as often claimed. The modern income tax, quite properly, emphasizes relative economic position. Surely, the taxpayer who protects himself against inflation by investing in common stock and real estate

is better off than the one who holds fixed-income securities or no equities at all.

(3) Full weight also has to be given to the perversions of tax justice growing out of the great tax differential between ordinary and capital-gains income. The wider that gap, the greater the temptation to distort the income-tax structure by giving ordinary income the form and appearance of capital gains.

4. The foregoing considerations lend support to the following policy propositions:

(*a*) Constructive realization of capital gains at gift or death would serve both equity and economic objectives.

(*b*) Tightening the capital-gains provisions to cut down opportunities for tax avoidance would improve the equity of the income tax as well as the pattern of investment.

(*c*) Narrowing the gap between capital gains and ordinary income by lowing ordinary rates would improve equity and stimulate investment. If revenue needs block this more pleasant solution, some upward adjustment of capital-gains rates can probably be made without serious adverse effects on investment.

Mr. MILLS. Our next panelist is Mr. Carl S. Shoup, professor of economics, Columbia University.

Professor Shoup, you are recognized for 5 minutes.

Mr. SHOUP. Mr. Chairman, my subject is the relation of capital-gains taxation to tax treatment of undistributed profits.

Avoidance of the personal-income tax is possible for high income investors who buy shares of stock in large corporations that are growing rapidly through plowing back most of their profits in the business. Shares of such corporations commonly grow in value over the years, and this increment in value is subject only to the low capital-gains rate when the stock is finally sold. If the stock is passed on to heirs, all of the gain accrued up to the time of death escapes the personal-income tax.

This escape is not really counterbalanced by the fact that the death tax—estate tax—reaches such property, for the death tax strikes also all property saved from sources that have fully paid the personal-income tax: savings from salaries, for instance.

The amount of Federal revenue involved may not be very large, but the question is still important because it affects the fair distribution of the tax burden. No one would defend a complete exemption of all individuals with an income of more than, say, a million dollars on grounds that the revenue loss would be insignificant.

The same kind of problem of fairness in taxation is involved in exemption from the personal-income tax—or taxation at low capital-gains rate—of income that originates in corporations and stays there, contributing to the corporation's growth.

The issue is not one of improper motives of directors of those large publicly held corporations that are growing by self-financing. Such directors base their decisions on business grounds and do not have tax avoidance in mind, at least not in the usual case of the large corporations. Still, tax avoidance is a result under the existing tax system.

The corporation-income tax strikes all earnings, distributed and undistributed, but it is a poor substitute for the personal-income tax,

so far as undistributed earnings are concerned. It is much too heavy a tax, if the low-income investor is considered; while for high-income investors the corporation tax is levied at a rate smaller than the marginal rate that would be applicable under the personal-income tax.

A special tax on undistributed profits would suffer from the same defects, being unfair to the low-income stockholder and inadequate with respect to the high-income stockholder.

How, then, can undistributed profits be brought to account in the tax return of the individual investor?

Forcing all profits out in dividends by a prohibitory undistributed profits tax would probably raise more problems than it would solve. Requiring the stockholder to enter in his return his share in the total corporate profits, distributed and undistributed—as a partner must do, with respect to a partnership—would be feasible, but it would encounter some serious practical difficulties.

A reasonably good solution seems to be to require that capital gains accrued up to the time of death of the stockholder, or up to the time he gives the stock away, should be accounted for at that time, and taxed to the stockholder, with some averaging device, to lessen the impact. This would be a solution only if the great differential that now exists between the capital gains rates and the regular rate schedule were substantially reduced.

And greater allowance for deductibility of capital losses would need to be part of the formula.

In any event, the two problems of how to tax undistributed profits and how to tax capital gains and allow capital losses are so closely connected that neither one can be fruitfully discussed if the other is ignored.

Mr. MILLS. Our next panelist is Mr. Stanley S. Surrey, professor of law, Harvard University.

Professor Surrey, you are recognized for 5 minutes.

Mr. SURREY. Mr. Chairman and members of the subcommittee, my topic is definitional problems in capital gain taxation.

The congressional policy decision to give a preferential income-tax rate to capital gains under the Internal Revenue Code requires a separation of capital gains from ordinary income. With the rate differential as large as it is today it is desirable that this separation be precise and clear.

In other words, we need a definition of capital gain.

However, in the 34 years since the adoption in the statute of the term "capital gain" in 1921 we have not succeeded in obtaining a workable concept for that term.

The income-tax provisions of the Internal Revenue Code of 1954 represent probably the most complex revenue law ever enacted anywhere. The subject singly responsible for the largest amount of this complexity is the treatment of capital gains and losses. Yet despite all of this complexity we have not achieved our goal of a precise definition of capital gain. Instead, each new complexity adds to the feeling that under the present treatment of capital gains the definitional difficulties are beyond solution.

In discussing the question of how capital gains should be taxed we always proceed as if everyone knew just what constituted a capital gain. We probably have in mind such matters as the sale of stock on

the exchange and perhaps some real-estate investments and let it go at that. But in fact the capital gain issue cuts across all of the ways in which a person can receive income. Congress has therefore been forced to classify all items of property and all transactions involving the receipt of income.

In attempting to divide transactions between capital gain and ordinary income, Congress has apparently had in mind the following policy judgments:

(1) A distinction is to be drawn between "investment" and "business," and only the profits from investment are to fall on the capital gain side;

(2) A distinction is to be drawn between "investment" and "speculation," with only the former resulting in capital gain;

(3) A distinction is to be drawn between "investment" profits and the rewards of "personal efforts," with only the former to be treated as capital gain.

It is obvious that the world of affairs does not present any neat division among these terms and the transactions they attempt to describe. Hence any effort at a separation in the tax law can hardly succeed.

Even if a particular item of property or transaction can be classified as involving ordinary income rather than capital gain, the taxpayer can generally make the classification pointless by changing his legal relationship to the property or transaction. Thus, inventory is not a capital asset, but if a sole proprietor incorporates his business he now owns shares of stock which are a capital asset though the value of those shares depends on the value of the inventory.

Business profits are not capital gain, but the appreciation in the value of corporate stock because of the corporate accumulation of business profits is capital gain. Dividends are not capital gain, but the appreciation in the value of stock in a Canadian investment trust which is accumulating its dividends is capital gain.

A tangible ordinary asset can thus be transformed into an intangible capital asset; ordinary income can be transformed into stock appreciation and consequent capital gain. In this game of transformation, our experience has clearly demonstrated that the draftsmen of tax laws cannot catch up with the taxpayer and his tax advisers. Although complexity after complexity has been thrown in the latter's way, the score is still comfortably in their favor.

I reach the conclusion that the definition of capital gain is not adequate to bear the heavy strain placed upon it by the present large rate differential in favor of capital gains. Unless that strain is eased, the situation can only worsen. To ease the strain I suggest the following principal changes:

(1) Reduce the present high rates of individual income tax in the top brackets while at the same time—and I emphasize this—eliminating the devices by which favored groups now escape those high rates, tax-exempt securities, the various natural resource tax shelters, the dividend credit, investment in life-insurance policies, and so on.

In other words, individual income-tax rates in the top brackets are too high today. They are too high precisely because Congress really thinks they are too high and Congress will not enforce these high rates of tax. Therefore, I can only conclude the rates are too high and that they should be reduced.

(2) At the same time reduce the present large differential between the treatment of capital gain and the treatment of ordinary income by (*a*) eliminating the present exemption of one-half of the capital gain; (*b*) increasing the maximum capital-gain rate to the level of the middle bracket marginal rates (as an alternative to explore, exempt one-third or one-quarter of the capital gain but do not have a maximum rate). With the high top rates reduced and the capital-gain rate increased, the differential will narrow for both those reasons.

At the same time, increase the allowance for capital losses.

(3) Contract the definition of "capital asset" by—

(*a*) Withdrawing the capital gain label from such areas as employee stock options, pension-trust terminations, oil and timber royalties, patent dispositions, real property and depreciable property used in business, and the like.

(*b*) Increasing the holding period to at least 3 years.

(4) Permit 3-year averaging of all capital gains, by spreading the capital gain pro rata over the current year and the 2 preceding years. Extend this form of averaging to other classes of income as experience is gained and as administrative feasibility and fiscal appropriateness are demonstrated.

These suggestions are only ventured and not guaranteed as a solution to the present definitional problems. They will considerably lessen the strain which is placed on the capital gain definition today and which that definition is incapable of bearing. While the suggestions, therefore, do not take us completely out of the woods, they will not lead us farther into the jungle.

Mr. MILLS. Our next panelist is Mr. J. Keith Butters, of Harvard University.

Professor Butters, you are recognized for 5 minutes.

Mr. BUTTERS. Mr. Chairman and members of the subcommittee, my statement was originally scheduled for presentation on an earlier panel, but I was unable to be here on that day, and I appreciate the opportunity of presenting it at this time.

I believe the topic actually ties in more closely with today's discussion than it did with the earlier one.

My topic is Effects of Taxation on the Investment Capacities and Policies of Individuals.

I am essentially giving a research report on a study of this topic undertaken by myself and other colleagues at Harvard University.[1]

Briefly, three main questions have to be answered in appraising the effects of taxation on the investment capacities and policies of individual investors.

1. Whose investment decisions are important?

2. How have taxes affected the investment capacity of these groups of investors?

3. How have taxes affected the investment policies of these groups?

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[1] The following findings are based on J. Keith Butters, Lawrence E. Thompson, and Lynn L. Bollinger, Effects of Taxation on Investments by Individuals—Boston, Harvard Business School, 1953. This volume is one of a series of studies on the effects of taxation conducted through the Harvard Graduate School of Business Administration and financed by a grant from the Merrill Foundation for Advancement of Financial Knowledge. The present summary, however, represents my personal interpretation of the findings of this study as applied to present economic conditions.

I should like also to stress that a great deal of oversimplification and some lack of balance inevitably results from an extreme condensation such as this of the results of a lengthy study on a complex topic. The best that I can do, however, is to refer the reader to the underlying research report for a more detailed and hence more precise statement.

I shall discuss these three questions in order and then indicate briefly some of the policy implications of our findings, as I see them.

WHOSE INVESTMENT DECISIONS ARE IMPORTANT?

Broadly speaking, the evidence leads to a clear answer to this question. From the standpoint of the flow of equity capital from private investators to business, the investment decisions of individuals in the upper income and wealth classes are of overwhelming importance.

I shall cite here only one of numerous sources of evidence in support of this statement, namely, the concentration in the holdings of marketable stock among different income and wealth groups.

Our best estimate is that at least 65 to 70 percent of all marketable stock held by private individuals is owned by families with a net worth of over a quarter of a million dollars. Classified by income groups, our best estimate is that approximately 75 percent of all marketable stock is held by the top 1 percent of all families.

EFFECT OF TAXES ON INVESTMENT CAPACITY OF UPPER INCOME INDIVIDUALS

The charge is frequently made that the severe rates of the personal income tax have, for all practical purposes, wiped out the capacity of individuals with large incomes to save. The reason for this widespread conviction is not hard to understand. The increases in personal income-tax rates since the 1920's have been so great that on superficial examination they appear to establish a prima facie demonstration of this thesis. Moreover, it can be shown beyond any reasonable doubt that the tax increases of the past 20 years have cut severely into the incomes of upper-bracket individuals and undoubtedly into their capacity to accumulate new investable funds, provided that the incomes of these individuals bear the full brunt of the individual income tax.

This demonstration, however, falls far short of showing that taxes have wiped out, or anywhere nearly wiped out, the capacity of upper-bracket individuals to accumulate new investable funds.

On the contrary, the evidence indicates that as a group individuals in the upper-income percentiles are still accumulating large amounts of new investable funds despite existing tax rates.

All the evidence indicates that the overwhelming majority of the individuals in the top 1 percent of the population—ranked by size of income—are still accumulating positive savings, and that at least half these individuals save a fairly sizable fraction of their income before taxes, say, one-fifth or more.

Two reasons account for these findings:

1. The habit of saving appears to be deeply ingrained in most individuals with moderate to large incomes.

2. There are numerous ways in which many groups of upper-bracket individuals—though not all such individuals—can accumulate investable funds without having them subjected to the full impact of the individual income tax.

In general, then, my conclusion is that the changes in the tax structure over the past 15 to 20 years have substantially reduced the capa-

city of upper-bracket individuals to accumulate new investable funds as compared with what they would have been able to accumulate under a less progressive tax structure, but that, for the reasons indicated, their remaining capacity is still very large—much larger than is popularly supposed.

EFFECTS OF TAXES ON INVESTMENT POLICIES OF UPPER INCOME INDIVIDUALS

The effects of taxes on the investment policies of individuals can be meaningfully discussed only in terms of the investment objectives of individuals. From the standpoint of tax effects, the most significant classification is between those investors who have capital appreciation as a main or important investment objective and those who do not.

The latter group, income-minded and security-minded individuals, tend to balance the current income of their investments against the risk of capital loss in making investment decisions. The high rates of the individual income tax tend to drive these individuals into lower yield, less risky investments than they would otherwise make.

In contrast, for appreciation-minded investors the single most important feature of the tax structure is the differentially low rate at which long-term capital gains are taxed in comparison with the much higher rates on ordinary income, especially for individuals in the upper income brackets.

This differential has stimulated inherently venturesome individuals to seek out investments which offered prospects of capital gains rather than the receipt of ordinary income.

As a consequence, it has caused this group of investors to shift funds out of relatively conservative investments, offering little or no opportunity for capital appreciation, and into more venturesome types of investments, such as relatively speculative marketable stocks, closely held companies, new ventures, real estate, and oil properties.

These tax-stimulated shifts toward venturesome investments by appreciation-minded investors have gone a long way toward offsetting the opposite shifts by more conservative investors.

Mr. Chairman, I have a section on policy implications as well.

I believe I have exhausted my time. Perhaps I should leave those points to come out in the discussion.

Senator DOUGLAS. I suggest Mr. Butters be permitted to finish.

Mr. MILLS. It will only take you a minute or so to finish, Mr. Butters. You may proceed.

Mr. BUTTERS. If you wish me to, I shall do so.

POLICY IMPLICATIONS

Time does not permit a careful discussion of the policy implications of the above findings. I wish therefore to make only one point which bears on various proposals for revisions in the tax structure. In recent years the existing tax structure has been only mildly repressive in its aggregate effects on the decisions of private investors, largely because it consists of a balance between repressive and stimulating elements; during the postwar years the stimulating incentives have, to a considerable degree, neutralized the repressive effects.

These stimulating incentives arise from opportunities provided by the tax law of obtaining income—or at any rate of accumulating in-

vestable funds—in ways that are not subject to the full rates of the individual income tax.

To many individuals these opportunities of avoiding the full impact of the individual income tax constitute undesirable elements of discrimination in the tax structure which should if possible be eliminated.

Thus, the dilemma is posed that the features of the tax law which provide from many standpoints highly desirable economic incentives are, at least in the eyes of many persons, and I would include myself in that number, the source of serious inequities.

In effect, the low-capital-gains rate—as well as the favorable tax treatment accorded certain industries—has made it possible to tax ordinary sources of income at exceedingly high rates without destroying the flow of equity capital from upper bracket individuals to business—at least in periods such as the recent past.

I believe it also follows, however, that—so long as the tax rates on ordinary income are continued at current levels and relatively riskless means of obtaining tax-exempt income remain readily available—any substantial tightening up of the capital-gains tax would go a long way toward curtailing the willingness of upper bracket individuls to make venturesome investments.

In other words, if the existing balance in investment incentives is to be maintained, any increases in capital-gains taxation would need to be offset by compensating reductions in the rates at which ordinary income is taxed and preferably also by a reduction or elimination of the existing opportunities for obtaining tax-exempt income from relatively riskless investments.

The purpose of these brief comments is not to recommend any specific tax policy toward capital gains but rather to comment in general terms on the relationship of the existing tax treatment of capital gains to my general conclusion that the overall repressive effects of the existing tax structure on the capacity and willingness of upper bracket individuals to make venturesome investments appear to have been limited in scope in postwar years.

Unless the delicate interplay of investor motivations and specific tax provisions which have produced this effect is understood, the precarious balance now existing could easily be unintentionally upset by revisions in specific portions of the tax structure made without full recognition of their overall effects.

Mr. MILLS. We thank each of you for your appearance this morning, and for the information you have given the subcommittee in the compendium.

As the Chair has said during each of our panel discussions, this subcommittee is primarily concerned with economic principles upon which tax policy for economic growth and stability should be based.

Today we are considering two of the most controversial issues in the Federal tax system—capital gains this morning, and percentage depletion this afternoon.

I think it is very important that we attempt to come to grips with the basic economic problems involved.

My first question, therefore, is, what is there in the character of a capital gain which calls for preferential treatment as compared with other types of investment income?

In other words, is it that a capital gain is not income, or is it the circumstances under which a capital gain is realized which call for the preferential treatment?

Mr. Brown?

Mr. Brown. I think that capital gain as generally used in a very loose manner actually constitutes various degrees of gain and income, so that we are actually in many cases talking about 2 or 3 different kinds of things as if they were the same thing.

We are all familiar, I presume, with the fact that many leading countries of the world, except for the United States, do not tax capital gains as such.

In these countries, the definition of gain is, I think, a somewhat narrower one than prevails in our present laws.

Therefore, I think the essence of the problem that your question raises is the fact that we have many different kinds of things that are being defined as one.

Mr. Chairman, I do not know how long you want me to elaborate on this point. Perhaps I have gone further than I should.

Mr. Mills. Well, if you can get me straight on the one point. We have preferential treatment for capital gain.

Do we have the preferential treatment because a capital gain is not income, or do we have it because of the circumstances under which a capital gain is realized, and these circumstances call for preferential treatment?

Now, which is it?

Mr. Brown. It would be my judgment it is a preferential rate because starting with our tax laws back in 1921, I believe, it was determined that capital gain should not be subject to full rates, because it basically is not income in the ordinary sense of the word.

Mr. Mills. Mr. Heller, would you comment on the question?

Mr. Heller. Well, I do not believe that that was the basis for our action, Mr. Chairman, in 1921.

It seems to me that we have recognized capital gains as a source of taxpaying ability, very much on a par with regular income.

Certainly, to the earner of wages and salaries who does not have access to capital gains, the increment of value of a stock must look like a very capable form of taxpaying ability, and I believe that the consensus, contrary to Mr. Brown's statement, would be that capital gains are income.

Now that leads us to the point, why give them preferential treatment if they are income?

It seems to me there are two main reasons for that: One is that they are income which are realized only at the option of the taxpayer.

In other words, he has more initiative in drawing down his income for tax purposes in the capital-gains field than in any other form of income. Therefore, we have to tread somewhat lightly on that form of income, or we may interfere unduly with the process of realization. The extent of that interference is, of course, a good part of the controversy over the lock-in effect.

The second reason is that the income tends to be bunched in 1 year. That is, the gain tends to accrue over a number of years, and if we taxed it under the full progressive power of the income tax, we would be taxing it unfairly. So, in lieu of giving averaging of some kind to

capital gains, we moderate the tax in order to take account of this bunching factor.

A third factor which might be added to these two is simply that we have a feeling, as Mr. Butters has discussed, that this is an unusually sensitive incentive area as far as new, venturesome investment is concerned.

In other words, capital gains are income but there are special circumstances of realization, and so forth, which call for special treatment.

Mr. MILLS. That justify or call for preference?

Mr. HELLER. They call for preference, not necessarily as much preference as we have, but they call for some differential.

Mr. MILLS. From an economic point of view, is there justification for the preference?

I understood you to say the circumstances called for preference.

Would the circumstances justify preference?

Mr. HELLER. Yes; I think the circumstances justify preference, though we should distinguish between the kind and the degree.

Mr. MILLS. Mr. Shoup, would you comment on this?

Mr. SHOUP. In this country, historically, the record seems fairly clear as to why capital gains were given preferential treatment, and that is the point emphasized by Mr. Heller, that capital gains commonly accrue over several years, rather than one, so that when they are finally realized, they have a tendency to bunch up and send the taxpayer far up into high income brackets, which constitutes discriminatory treatment in comparison with the taxpayer whose income is spread more evenly over the years.

This was shown by the measures taken in 1921 and was shown especially by the five-stage step scale that was put in in the thirties.

However, if we look at the present treatment, we find it I think difficult to justify on any grounds except the following: That we have on the one hand a group of individuals who believe that capital gains should not be taxed at all; on the other hand, we have a group of individuals who believe that they should be taxed as income, but including some averaging device.

These two groups of individuals are unable to reach common ground in principle, and consequently, since some compromise must always be effected, we emerge with the present law, which has a 6-month holding period, which is ridiculous from the point of view of averaging, and a one-step scale from 100 percent down to 50 percent, which is also hardly justifiable under the same principle. Consequently, we have a tax law that does not satisfy either group of individuals, but represents the only common ground on which they could eventually meet.

With respect to the purely economic point of view, I find it difficult to discern any grounds for truly preferential treatment of capital gains, as compared to other sources of income.

I do not consider an averaging device preferential treatment. I regard that, rather as simply rectifying an injustice, and, indeed, we probably need some sort of averaging provision which has a more general scope than the present bits and pieces of averaging that are at present in the income-tax system.

It would require a much stronger showing than has been made up to date, I believe, to say that the capital-gains type of accretion to eco-

nomic power should be given truly preferential treatment as compared with the economic power represented by wages, by interest, by rent, and other kinds of income.

Mr. MILLS. Mr. Surrey, will you comment on the questions?

Mr. SURREY. In the first place, I think the question of averaging is really beside the point. It is quite true that the entire capital gain is included in income in 1 year for tax purposes, although it may have grown up over several years and it would therefore be appropriate to average capital gains. But you could average capital gains all day and no one would be satisfied with that treatment.

Let's assume we permit people to average their capital gains. For most wealthy people, the rate of tax on capital gains would still be 80 and 90 percent, although they could spread the capital gain over several years. The spreading would still keep them in the top rates of tax because they are wealthy people whose other income places them in the top brackets, consequently, averaging will not end the problems in this area. You can grant averaging and you will still be faced with pretty much the same capital-gain problem that you are faced with today—the question of whether there should be a preferential rate.

I am a lawyer, and I have to yield to my economist friends on this question of a preferential rate. I do start with the idea that a dollar is a dollar, and if a person receives a dollar, then he has the same tax-paying capacity as the person receiving a dollar in any other way. I think Mr. Heller's point is here pretty convincing. A person can argue all day that the capital gain he receives when the stock market goes up and he sells is not income. However, he will never be able to convince the fellow who didn't have that capital gain, whose stock didn't go up, or who didn't own any stocks that the first person didn't have income. So I start with the viewpoint that these capital gains are dollars received by people and are like any other dollars. On equity grounds they therefore should be taxed the same as any other dollars.

The question then arises whether there are any overwhelming economic considerations which demand that we give some tax preference to these capital-gain dollars? On this point I don't place much stock in what other countries do and the fact they may exempt capital gains. Other countries have capital levies, but we don't run and have a capital levy. The laws of other countries are not very persuasive, as to what goes on here, because traditions and conditions in other countries are different. We are forced back, I think, to the matter on which my economist friend for my part will have to advise me on, that is, is it necessary to grant any tax preference to capital gains for incentive reasons or other economic reasons? The burden of proof would be on the person urging the incentive reason, however, because tax preferences on incentive grounds have to be justified—have to bear a very large burden of proof. The question in this case is, can the capital gain preference bear this burden of proof?

Mr. MILLS. Is it your opinion that it can or cannot?

Mr. SURREY. Congressman, I have no basis for a definite judgment. The pressures upon Congress in this area are obviously going to be very great. I think Congress has gone much too far with respect to this tax preference. But I would not change it all overnight. I would attempt to lessen the differential considerably, both by reduc-

ing the high rates of individual income tax and by bringing the capital-gain rate up. I think that my economist friends, as far as I can gather, tell me that for the time being I would have to leave, however, some preference existing.

Mr. MILLS. Mr. Butters would you comment on the questions?

Mr. BUTTERS. Yes, sir.

I have no difficulty in reaching the conclusion that realized capital gains do represent taxable capacity to individuals. I think the question as to whether you define them as income or not is a semantic question, and the really basic question is, do they represent taxable capacity?

I believe the reason—the justifiable reason—for the preferential treatment for capital gains is the economic impact which would result if capital gains were defined as ordinary taxable income, given the present rate structure that we have on ordinary income in this country.

I think these economic effects would take two forms. First, I believe that the locked-in effect which Mr. Brown has referred to would be a very serious effect if capital gains were defined as ordinary income under present tax rates. I would not agree that the effect is anything like as serious as he has stated it under the present rate structure.

Secondly, I agree with Mr. Heller that there would be a serious adverse effect on people's willingness to make venturesome investments if capital gains were defined as ordinary income under present tax rates, and if present opportunities for obtaining tax-exempt income and relatively riskless investments remained unchanged.

Mr. MILLS. We have used the words "preferential treatment." Let me ask the question, is our present treatment of capital gains preferential or differential?

Mr. Brown?

Mr. BROWN. Speaking from the point of view of capital gains as a form of increment in capital and not a form of income, it would seem to me that the word "differential" would be preferable to the word "preferential."

The word "preferential" connotes something that is in preference to something else, and I don't think—in my judgment the word "differential" would be better. However, it is commonly described in laws as preferential treatment.

Mr. MILLS. Mr. Brown, take the case comparing interest and appreciation in stock values. Today I buy Government E bonds for $18.75. Ten years from now, because of the additions from interest, it will net me $25. Today I buy a piece of stock in some corporation that costs me $18.75, and it happens that 10 years from today I sell that stock for $25. Now, under the circumstance, the first is taxed as ordinary income, and under the second circumstance the gain is what we call a capital gain under existing law.

Under the circumstances, is that treatment of a capital gain preferential or is it differential?

Mr. BROWN. The capital gain it seems to me in that case is still subject in my mind to a differential rate. I would prefer the word "differential" to the word "preferential." I am not sure, Mr. Chairman, that I understand the difference of the connotation that you

wish us to discuss between the word "preferential" and the word "differential".

Mr. MILLS. The reason I asked the question is that I noticed in the papers the use of both expressions: Differential treatment, and preferential treatment. I am really trying to find which it is, preferential or differential.

Mr. BROWN. I would say this: That I think there is quite a difference between taxing the income on the bond, which is a form of income and which is always in most countries of the world considered as income. It is the annual return from lending people money.

Differentiate that from the changes in the capital value of an asset, which may come about due to inflation and it may come about due to many reasons. In the old common law of England, there is a difference between the apples that come from the orchard and the cutting down of the trees that constitute the orchard itself, and in my opinion, there is a substantial difference.

Mr. MILLS. Mr. Brown, pardon my interruption of your thoughts, but if a thing constitutes preference under tax law, we may not be able to justify it. If a thing constitutes a differential, circumstances may justify the differential in treatment; isn't that true?

Mr. BROWN. Yes, sir.

Mr. MILLS. It is much harder to justify the preference; isn't it?

Mr. BROWN. In answering the question originally, I suggested my feeling would be the word should be "differential" rather than "preferential."

Mr. MILLS. In other words, as far as tax policy for economic growth and stability is concerned, if the difference is to continue in the future, it should be continued because circumstances justify a differential in treatment, not a preference in treatment.

Mr. BROWN. I think I would prefer the word "differential" and I would agree with you, sir.

Mr. MILLS. So you would come to the conclusion that Mr. Surrey has stated, namely, a differential in treatment must be viewed in the light of circumstances and treated in the light of the circumstance?

Mr. BROWN. Yes, sir.

Mr. MILLS. And justified only on that basis?

Mr. BROWN. Right.

Mr. MILLS. Mr. Heller would you care to comment on my question?

Mr. HELLER. It think it is a preferential differential. That probably compounds the confusion.

Mr. MILLS. I might say I am prone to agree with that, a very compromising position.

Mr. HELLER. Then I will pass.

Mr. MILLS. Mr. Shoup?

Mr. SHOUP. I believe it is preferential, but also shall we say "happenstantial." It came about through this process of conflict and compromise that I described and it is preferential in the sense that it has gone far beyond the original logical reason for differential treatment, which was the averaging idea. Let me say that I wish to associate myself with Mr. Surrey's remarks on the ineffectiveness of averaging at the very high income levels, and that, as my paper indicates, I believe that any removal of this preferential treatment would have to be associated with a substantial lowering of the high-bracket rates, which are impractical if they are to be truly enforced.

Mr. Mills. Mr. Surrey?

Mr. Surrey. Well, I think as the previous speakers have indicated it is partly a question of semantics and of your basic attitudes. I am inclined to think that those who believe in the present treatment will tend to call this a differential. As a matter of fact, they may go further and say that the present tax is a "penalty tax" on capital gains.

I think it depends on your attitude. I happen to start with the attitude that, equitywise, all dollars should be taxed the same, so I would tend to call this a preferential treatment. In large part these words may well be the labels that we put on the conclusions we would like to reach.

Mr. Mills. Mr. Surrey, in determining tax policy for any purpose, the Congress, of course, must bear in mind any definition of terms which has been established under the Constitution by the courts.

Is there any definition reached by the courts with respect to capital gains and income that we should bear in mind in attempting to formulate tax policy in this field?

Mr. Surrey. I can see nothing in the decisions of the courts or in the legal background for this area which would prevent the Congress from taxing capital gains as ordinary income if it decides to do so. Also, I see nothing to prevent Congress from adopting Professor Shoup's suggestion, made elsewhere, that you can tax each year the increase in the value of an asset, whether that increase has been realized or not.

In other words, in this area you have a free hand within the boundary lines of what would be sensible action. Any rational action that you decide to take in this area would be well within the boundary lines of Supreme Court decisions and the constitutional background.

Mr. Mills. Senator Douglas suggests, Mr. Surrey, that you might comment on whether or not the courts have been as imprecise in definitions as the Congress has been on capital gains.

Mr. Surrey. I beg your pardon?

Whether the courts have been?

Mr. Mills. As imprecise in definitions of capital gains as the Congress has been.

Mr. Surrey. Could I just answer that question?

Mr. Mills. I want you to. Let's get the record straight. I share Senator Douglas' viewpoint that you answer it.

Mr. Surrey. The Congress has given an impossible job to the courts in this area. Let me just illustrate this.

The Supreme Court had a case the other day which involved a company engaged in manufacturing sugar products for corn, and it had an inventory of corn. Its inventory would obviously be an ordinary asset and its profits would be ordinary profits. This company did not want to gamble on having enough actual corn on hand and so it bought corn futures. Sometimes it took these futures down and used the corn itself. Sometimes it didn't need all the corn represented by these futures, and it sold the corn futures at a profit. Was the profit capital gain?

Well now, all that you gentlemen in Congress said in the tax law in the definition of capital gain was that a capital asset is all property except inventory.

Now, what did you want the Court to do with this case? Did you want the Court to say that dealing in corn futures, which is dealing in

property, resulted in a capital gain, or did you want the Court to say, "Now look, these corn futures were very close to its inventory, its regular profits, its normal business profits, and therefore should be ordinary gain."

This is a very difficult problem for the Court, because they didn't believe what you said in the tax law. They didn't believe that you meant that all property is a capital asset producing capital gain except inventory. They said, "We believe Congress did not intend to go that far. Therefore, the profits here are ordinary profits."

This is an impossible job for a court to undertake and that is one of the prime difficulties in this area. You gentlemen, unfortunately, are in this position: The decision having been made to tax capital gains at a low rate, your draftsmen have been unable satisfactorily to implement that decision, and the poor courts are struggling with these problems without any real guidance.

Mr. MILLS. I have always had difficulty, Mr. Surrey, understanding the right of the court to say that they didn't believe the Congress meant something, or disagreed that the Congress did mean something, but in this particular area, I imagine that the confusion existing in the courts with respect to what is capital gain is somewhat comparable to the confusion that has existed in the Congress as to a proper definition of capital gain.

That definition in the code, the code of 1954, which in some instances is an improvement over the code of 1939 in this respect, still defines capital gains as best the Congress can define it by exclusions and by inclusions, necessitating countless numbers of sections to the code.

I think it is generally agreed that there are more sections in the code dealing with the subject of capital gains than any other concept or any other idea of income.

Perhaps tax policy for long range growth would require a better definition of capital gain than the courts have reached in the confusion created by the Congress, or the Congress has been able to reach because of confusion it has been in. Would you agree that there is need in the long run for a better definition of capital gains?

Mr. SURREY. I agree there is need for a better definition of capital gain. I doubt—I am very pessimistic—whether one can ever be obtained and that frankly is one of the problems that I see as a lawyer in this capital gain area. And I say this as one who has worked the last 7 or 8 years in a research study with respect to a technical revision of the tax laws.

My conclusion has been that this area tends to get nearly hopeless because of the fact that you have to classify every single transaction between capital gain and ordinary income. The ingenuity of lawyers here is too great, and the task of classification may be hopeless, given the very large preference or difference in the rates today.

Mr. MILLS. Based upon your experience in the law, including your years of service with the Treasury, when I knew you very favorably——

Mr. SURREY. Thank you.

Mr. MILLS. And also including your years as a professor of law at Harvard Law School, could you give us any general definition that might help me in properly defining capital gain? I don't ask you that to embarrass you nor to put you on the spot, but if we have been unable to devise a satisfactory formula in the Congress, with the advice

of our staffs and the people in the Treasury, then maybe we could get such a definition by going to the outside.

Mr. SURREY. I am not going to be able to give you that definition today, Congressman Mills. In a sense you have to tell me, how do you want a patent treated, how do you want a copyright treated, how do you want the man treated—well, let's take this case that came up the other day in a court. A corporation owned a million acres of land. It wanted to get rid of these million acres of land. It took about 20 years or so to sell a million acres of land—a bit here, a bit there. You will have to tell me whether you want to regard that corporation as being in the real estate business with ordinary profits or whether you want that corporation to be considered as liquidating an investment and have capital-gain treatment. You will have to go through a lot of transactions and give me your value judgments on them. As long as you are going to have this preferential treatment you will have to answer a lot of cases for me, and only after you answer them can I as a draftsman say, I think I understand what your policy is and I will try to work it out. I realize I am answering in an indirect fashion. But if you will pardon me, sir, I do so simply because I really don't think the Congress has realized the extent to which this difference in treatment has cut across all of tax law, has made a good deal of the partnership provisions, the corporate provisions, and other provisions nearly hopeless in their complexity. One cause of this difficulty is that the difference in treatment between capital gains and ordinary income is so great. I think if you were to reduce this difference in treatment, so that far fewer people would have the question before them whether this is a capital gain or isn't a capital gain, the problem would be a little easier on the definitional side.

Mr. MILLS. Without any desire to embarrass or to put you in the position you don't want to be in, are you saying that actually there is no real hope that we can attain the goal of a satisfactory definition of capital gains for future tax policy?

Mr. SURREY. I would say that you have to realize there is no such thing as a settled concept of what is capital gain. It is an artificial concept peculiar to the tax statute. The economists, accountants, lawyers, can't give you an answer by resort to the concepts of their professions. The capital gain concept is merely a general concept of Congress that certain activities associated with investment are to get some preferential tax treatment. I think that you may conceivably, by being pretty strict—pretty strict on what you will cover—mark out an area associated with investment activities which may give you a reasonably satisfactory definition of capital gain, if you don't put too much strain on this definition.

Mr. MILLS. I read again your statement, as well as the statement of the other panelists appearing today, in the compendium. Again, I was impressed with the fact that perhaps the hope for the future is to reduce some other type of taxation in order to minimize the need for further characterizing types of income as capital gain.

Now you have said that in your statement in the compendium. You have said it this morning. That, to me, makes me think that perhaps we are to continue, therefore, to be plagued with the determination in the future of capital gains, just as we have been in the past. Reading what the Court interprets as to what the Congress either intended

or didn't intend, and then if the Court interpretation suited the Congress, writing that into the law as a part of the definition, and if the decision of the Court did not suit the Congress, writing in, then, the contrary, as the congressional definition of capital gain. In the process, every time a new tax bill of any magnitude has been before the Congress, we have had requests to transpose some particular transaction or transactions from normal income, and the high rates applicable thereto, over into the capital gain territory with the lower rate.

Until we reach the time, then, when we can reduce these upper bracket income-tax rates, you contemplate that that will continue to be the best procedure for the Congress to follow?

Mr. SURREY. I didn't get the last statement, which would be the best procedure?

Mr. MILLS. Continuing this practice of viewing each case to see whether or not the Congress desires to enlarge upon the definition of capital gains, to include this particular situation that is now treated as normal income.

Mr. SURREY. Congressman, I think, frankly, you are in a very difficult position. We have very high rates of individual income tax. We have something over here, which is a nice little basket labeled "capital gains." If anyone can get his transaction into that basket, he has cut his rates from 91 percent to 25 percent. It is quite obvious under those circumstances you are going to be deluged with people saying "My particular transaction is a capital gain and it should have this label." As long as you have a basket over here called "capital gains," the pressures are going to be enormous on you to say that this transaction results capital gain, that thus actively is capital gain, etc.

Consequently, I doubt very much whether you want to get into this situation, because you are simply then going to be put in pretty much the situation that tariff laws and the like involve—where you are going to have to classify a great many individual transactions and be subject to pressures with respect to each classification. I doubt whether the Congress wants to get into that difficulty, and yet it is slowly getting into it.

You have in the revenue laws solemnly declared what happens to growing crops on land, what happens to breeding cattle, and other animals, except poultry; you have dealt with timber royalties, you have dealt with coal royalties, you have dealt with copyrights, you have dealt with patents. I doubt whether you want to get in this position of going transaction by transaction, and yet I agree with you that under the present situation I see no particular alternative.

Mr. MILLS. Well, because I had always thought that preferential treatment was perhaps self-destructive in that a granting of a preference in one instance, that is, that this we have always considered to be normal income shall now be considered a capital gain, breeds other requests and pressures on the Congress to change the classification of other income to capital gains.

I was in hopes that as a result of our panel discussion this morning, though we might not come up with a perfect definition, we could come up with some broad principles that this committee might include in any report it cares to file that would be a guide in the future to the Congress, and to everyone else, in determining the true classification that in the future should be given to capital gains.

Mr. SURREY. I think that is a very important objective, and assuming that there is to be a capital gain differential, that seems to me really the basic way in which you have to proceed.

I might add it would seem that at least two things can be said in this respect. The Congress should as far as possible seek to confine the capital gain area to true investment activities. Consequently it should look with extreme skepticism on those urging capital-gain status for activities which fall more properly in the area of business or speculation or which involve rewards from personal efforts. The Congress also should be careful not to place the capital-gain label on a transaction or activity simply for the sake of providing a lower rate of tax in that fashion. Thus Congress has from time to time given capital-gain status to activities really bearing no resemblance to a capital gain. I have reference to pension-trust terminations, employee stock options, coal royalties, and such. Here for one reason or another, Congress wanted to grant a preferential rate and did so by attaching a capital-gain label. This can only serve to confuse the whole problem of defining capital gains. Assuming that the Congress desires to grant favorable treatment to these activities, which is in itself, of course, a debatable matter, it should do this in some other fashion than by artificially calling the activity a capital gain.

Mr. MILLS. I haven't asked Mr. Butters to comment on the attached original question that I put to the panel preceding these other questions, but as you comment on that, would you endeavor to see if you can give us some broad principles that we might rely upon for tax policy in this area?

Mr. BUTTERS. The main conclusion I would draw from this discussion, and particularly from Mr. Surrey's remarks, Congressman Mills, is that it is going to be extraordinarily difficult to do this, and that therefore the clearest policy indication is to try to minimize the importance of the definition, rather than to improve a definition which Mr. Surrey has been studying for 8 years and has been unable to come up with a recommendation for improving. I have been struck by one fact in reading the general papers that have been submitted in connection with this hearing, and that is, practically everyone who has faced the problem, be he conservative or be he liberal, has objected to the very high top rates of the individual income tax. They have done it, I think, for entirely different reasons, the conservatives because they don't like high tax rates; the liberals because they realize that the present high tax rates have almost their main effect in creating exceptions to those rates. I would therefore conclude that, because of the inherent difficulties in this problem, the wise policy action is to try to minimize the degree of the difference and the importance of the difference by narrowing the differential in the rates between ordinary income and capital gains.

Mr. MILLS. Mr. Heller, in the course of these hearings it has been repeatedly suggested that one very important objective of tax policy for the future should be to increase the built-in stabilizing capacity of the Federal tax system. How would you evaluate the present tax treatment of capital gains in this respect?

Mr. HELLER. Mr. Mills, I appreciate the opportunity to address myself to that comment, because in the process of transmitting my paper, a paragraph or two I had written on that subject was dropped

out. This is a rather fortuitous opportunity to salvage them. If I may, I should like to read them into the record:

Perhaps a few words should also be added to my earlier discussion of the impact of the capital-gains tax on stability. Part of this impact depends, of course, on the role of the tax in increasing or decreasing the stability of the security markets. But another part depends on its role as a contributor to the stream of income tax revenues. Does it strengthen or weaken the automatic stabilizing pattern of these revenues? Since changes in net revenues from the gain-and-loss provisions depend more on changes in security prices than any other factor, the answer is geared largely to the correlation of stock-market swings with swings in the economy as a whole.

To a considerable extent, stock-market booms generate large gains tax liabilities when abatement of inflationary pressure is desirable and small liabilities or even tax losses in depression, though the timing is by no means precise, and conspicuous exceptions have occurred, that is, 1941 and 1942.

Now, I want to illustrate that by what is happening today, plus just a little bit of historical description. In the period 1926 to 1929, for example, the capital-gains tax accounted for 40 percent of the total individual income-tax yield. Then in 1931 to 1932, because of the capital gains and loss provisions, the income-tax yield was reduced by about 25 percent. In other words, there was a very conspicuous increase of the built-in stability, the stabilizing effect, of the income tax from the capital-gains tax.

Now those proportions today are no longer that high, but the absolute amounts are not at all insignificant, and I think that the occasional statements to the effect that "We could eliminate the capital-gains tax because the revenue involved isn't very large anyway," are very much wide of the mark.

In the 4 latest years for which we have precise information, the capital-gains tax—1948 to 1951—yielded about six to seven hundred million dollars a year. Now, in 1951, it yielded $900 million on about $6.1 billion of capital gains on a 100-percent basis. We must be running at least $10 billion of gains this year. Applying the average rate of tax derived from past experience, our capital-gains tax this year would probably yield about $1⅓ billions. As I say, I think that is a significant contribution to the stabilizing impact of the income tax. It is coming at the very time when we are in a boom period.

Mr. MILLS. Mr. Curtis will inquire.

Mr. CURTIS. Mr. Surrey, I want to start with you because I think you have been discussing the basis of these issues.

I was intrigued when you say that the Congress was given a responsible job and the discussion revealed that maybe Congress is trying to do an impossible job. Then I might, in turn, say "Poor Congress" and then, because Congress relies upon economists to try to tell us what the proper economic analysis of a particular transaction is, maybe it is "poor" economists and lawyers we come back to. Because I think essentially in this problem is the question of what is the proper economic analysis of these transactions where we are trying to say what is a capital gain or what is ordinary income.

Wouldn't you say that that lies at the base as the very difficult problem of trying to make a correct economic analysis of what does go on in this quite complex society of ours?

Mr. SURREY. I think that is correct, Mr. Curtis.

Mr. CURTIS. The grain futures, of course—I don't know what the answer to that is, but I don't think that I agree with the "poor" courts.

I don't remember that specific case, but when the whole issue was before the Ways and Means Committee, I was feeling pretty sorry for myself and colleagues because of the problem then. We passed it back to the staff, who were supposed to be able to analyze these things, and they went out and got economic and business experts.

I felt a little sorry for the poor experts, too.

I want to get back to a basic point on the 16th amendment: whether we go away from this business of trying to differentiate between capital gain and ordinary income, we still would be required ot make a definition of what is a capital gain, would we not, because the 16th amendment forbids it to be a capital levy. Am I correct in my interpretation of that?

Mr. SURREY. The 16th amendment states that you can levy taxes on income from whatever source derived.

Mr. CURTIS. Yes.

Mr. SURREY. The Supreme Court, in its interpretation of that amendment, insofar as this aspect is concerned, has said that if I buy something for $100 and it appreciates to $150, the $50 is income and can be taxed.

Mr. CURTIS. But by implication it is true that they say that that does not give the Congress authority to make a capital levy.

Mr. SURREY. That is correct, but in this context, no one has gone that far in urging that.

Mr. CURTIS. What I am getting at is whether the Congress is still faced with the problem in some of these complex transactions of being certain that we are dealing with what could be called economically a capital gain, as opposed to what economically could be regarded as a capital levy.

Mr. SURREY. Yes; except that Congress has always said that a person shall not be taxed until he first has received his cost back, and we are only dealing with the gain or the increment on his cost.

Under these circumstances, we are not involved, I believe, in the difficulties that you envisage.

Mr. CURTIS. I think it is sometimes extremely difficult to determine whether a particular transaction which is complicated is a capital levy or a capital gain; regardless of our disagreement as to whether it is difficult, you would agree, though, that Congress cannot make a capital levy, if that is what it economically was. It would have to be a gain?

Mr. SURREY. Yes.

Mr. CURTIS. Now I come to the even more basic point, and what I suggest is maybe one of our difficult problems in this whole thing, disregarding this problem that we do have between the capital gain and ordinary gain; the fact that we mess around with the dollar so that it isn't a measuring stick, or it hasn't been an accurate and stable measuring stick of an economic transaction. So that through inflation, which is an added increment, actually we do have a capital levy, or can have a capital levy, economically speaking, imposed after a sale, let's say, of a particular asset.

I will illustrate an obvious situation which is simple by my own case. I came back from World War II, having left, I might say, with just one child in the family. When I returned back to the community, though, I had to find larger quarters, so I had to sell my home on that market and then buy into the other.

It certainly wasn't—and Congress later picked it up, but it didn't help me—Congress corrected that on the basis of an actual statute but economically speaking, that actually was a tax, the tax I paid on the differential between what I paid for that house and what I sold it. It actually was a capital levy. Do you agree economically?

Mr. SURREY. No.

Mr. CURTIS. Why don't you thing economically that was a capital levy?

Mr. SURREY. Because we will get down to what our definitions of capital levy and capital gains are.

Mr. CURTIS. That is the point.

Mr. SURREY. You spent a certain amount for that house and you sold that house for dollars in excess of that amount.

Mr. CURTIS. Yes.

Mr. SURREY. Therefore, just using a dollar as a dollar, you had a gain on that house. I might say, you might ask the question: should we count a dollar as a dollar?

Mr. CURTIS. I said economically. That is the whole issue, as to whether or not the fact that the dollar has not been stable and has not been a true measuring stick, and I am again saying economically, what we have done in many instances is created a situation where we economically are having a capital levy as opposed to a tax on a capital gain.

Mr. SURREY. I just want to say this, and I think I should then bow out to my economist friends: Throughout the entire income tax we count a dollar as a dollar. If my salary goes up because of inflation, I move into a higher tax bracket, simply because I have inflated dollars.

Mr. CURTIS. You are talking about something that could move with inflation like salary, perhaps?

Mr. SURREY. In your case, Mr. Congressman, I might venture to suggest that your gain indicated that you were one of the fortunate beneficiaries of inflation in that you had a house to sell. The fellow who didn't have a house to sell didn't benefit from inflation, relatively speaking. I say relatively speaking, because the capital gain in your case indicates your position under an inflationary situation, as compared with X, who either had no house, or a fixed asset, like a bond, which didn't go up in value.

Mr. CURTIS. That is right. I had a hedge.

Mr. SURREY. From an equity standpoint it is appropriate to tax you on your gain because you did have a gain relative to the other person who didn't have a house.

Mr. CURTIS. I wasn't trying to get into equity, but stick on to the actual situation. You can multiply that on out into many things. That this fact lies at the base of this problem that Mr. Brown poses about the locked-in situation, where many of the investors are remaining locked in to avoid what would amount to a capital levy tax, as far as their particular interest is concerned.

It is true that from an equitable standpoint people who really suffer are those who are on pensions and have no hedge against inflation.

I might state all this talk about tax reduction and tax benefits in terms of taxpayers it is forgotten that this terrific tax on inflation has hit those groups, and they are not the conventional taxpayer

so we have not been talking much in terms of benefiting them in our tax reduction.

Mr. SURREY. It is all relative. A person on a pension may be hit by inflation. But he may be better off than a person with no pension at all. It seems to me that unless you want to be lost in the wilderness you have to say that "Here is a person with dollars and the dollars are the same as the next person's dollars and we levy taxes on dollars."

Mr. CURTIS. I am not trying ot argue the equities, once we understand what the economic situation is, that is why I am trying to suggest that a good bit of our problems that arise right now in our field of treatment of captial gains, although I agree with you that the basic problem lies in trying to differentiate between ordinary income and capital gains.

Nonetheless, that problem has been severely aggravated by the effect of inflation.

Mr. SURREY. I think it is quite correct that thinking through these problems is necessary if we are to get to the roots of what we are discussing today.

Mr. CURTIS. I think that whatever Congress wanted to do, we still are going to have to mess with the problem of trying to distinguish what is a capital gain as opposed to what might be a capital levy.

Now one thing I would like to address to Mr. Heller:

In an analysis of this whole problem, we in effect are confronted with this proposition, that the dollar actually is two kinds: One that can be the consumer dollar, the dollar that is spent for consumption and the dollar that is spent for investment, and there can be a shift between those.

In other words, the dollar that could be a consumption dollar could become an investment dollar and likewise an investment dollar can be transferred to consumption, and when we are talking about this differentiation between taxing those two kinds of dollars, we are concerned with the incentive to encourage the individual.

It all comes down to his decision. We encourage him to shift his dollar from consumption to investment or conversely to discourage the individual from shifting their dollars from investment to consumption.

Now would you say that is a fair analysis of the basic problem that is involved in this area?

Mr. HELLER. Yes; I think it is, Mr. Curtis. I think, however, you have to go behind that and ask, as this committee has been asking, what is the proper balance between consumption dollars and investment dollars?

Mr. CURTIS. There is that shift, and I imagine it could shift too much the other way. It is the balance of the thing. We could get too much going into investor dollars.

Maybe the shift would go the other way. The history of mankind up to date, at least from my observation, our problem is to get the dollar into investment as opposed to consumption.

There seems to be a very basic human urge to do the consuming, and it requires more effort, I would say, to convert to investment than consumption.

That is just an observation I make.

I wonder if you would comment on that?

Mr. HELLER. I do not deny the urge, but the wherewithal to convert that urge into market demand also has to be given very careful consideration in drafting tax legislation. It is entirely possible that we may overstimulate investment at times to the point where it gets out of line with demand. We sometimes seem to lose sight of that possibility in the process of sacrificing most everything at the feet of the great god investment.

Mr. CURTIS. A lot of papers before and the papers today talk about this need for capital formation in our society and how much we are going to need each year, but I have been a little bit concerned to find that there is not too much agreement among economists as to how you measure, or how you estimate how much capital formation is needed.

We had two different tests applied, or factors that were applied, the estimating amount of investment needed per worker, and that figure ranged from about $11,000 to $13,500 as I recall it.

On that basis of course we could estimate the amount of additional capital, new capital formation needed each year.

We know, for example, there is going to be about a million new potential workers for each year. It is running about that ratio. That would indicate we do need about $11 billion of capital investment to take care of that normal economic growth.

Another set of papers or group of thinking said that the estimate of how much capital formation we needed should be tied into consumption and I did not quite follow the logic of it to be honest with you, but at least there was an emphasis on the point that we measure the need for capital formation by consumption, and if we continue to encourage consumption, that therefore, I presume, that that will take care of the forming of the necessary investment of capital.

Do you have any comments that you might make on how we might measure the need for new capital formation? Incidentally, let me interject this. I was eliminating from discussion the capital formation needed for replacement. I am trying to think of the growth.

Mr. HELLER. I cannot claim to have made any calculations or even seriously considered the best way of making such calculations.

I think a great deal of it is not a technical question at all, but a matter of value judgment. That is to say how much of our current consumption do we want to give up in order to plant the "seed corn" for future economic expansion?

In other words, the question can't be resolved in economic terms alone.

Mr. CURTIS. Do you think we have control over it or even should have control over it?

That is one of the points that is made on this consumption thing. If you stimulate your consumption, that will bring about the required capital formulation to meet it, and that would bring about the growth, instead of this more arbitrary approach perhaps of looking to see how many new workers we are going to have and what we are going to have in the way of capital formation to put them to work.

Mr. HELLER. Well, the way you have just stated it happens to fit in with my prejudice on the matter. That is to say, I think we are somewhat safer in the long run if we have consumption lead the rate of capital formation and also its composition.

I am a little uneasy about measures which are designed to stimulate various forms of investment, particularly when they are in the form of, let's say, percentage depletion, and other very special forms of preference. In other words, when we stimulate investment directly by special tax preferences, we may distort the allocation of resources in an uneconomic fashion.

Mr. CURTIS. I don't think that your percentage depletion and certificates of necessity, dividend credits, and so forth, which are stimulation of a certain type of investment, necessarily effect the overall amount of capital formation to any extent, do they?

Mr. HELLER. Well, there you put your finger on an important point. That is, I was stressing the allocation among different types of investment, but let's look for example, at the impact of percentage depletion. Provisions on the balance between consumption and investment.

If our present method of percentage depletion grants taxpayers a tax reduction of, say, three-quarters of a billion dollars in comparison with cost depletion, then certainly we are giving not only a special benefit to investment in depletable activities but we are giving a benefit to investing in general in the sense that we are likely to increase the sum total of investment. We are likely to draw some of the resources that might have gone into consumption over into investment, so the two are related in that sense.

Mr. CURTIS. They might be.

Incidentally I might comment on this, whether it is preferential or differential.

I lean toward differential for this very reason: preferential seems to have an overtone of relating to individuals, while actually any individual can go into any of these fields of endeavor, and so gain this differentiation.

If there were not a freedom of choice of individuals, or if there—if for some reason or other any of these tax provisions are so worded that it is not open to all individuals in our society I should think there might be some basis for use of the word "preferential" but as long as it is to achieve an economic result and it is open—well in fact if it is going to achieve that result it has to be open to all citizens or it probably would not achieve it, so I would choose the word "differential." But that is just a comment I wanted to put in there.

The second question—first, how much capital formation do we need, and I have reviewed that a little bit, and then the next question, it seems to me that this is the area where we get into our problems, where do we get it. One thing I find that has not been too apparent in the thinking of the various panelists is the fact that one very great source of capital formation is the Federal Government, and in the past few years it has been resorted to, to a very marked degree. Commenting on your use of consumption and demand as a test, or rather as an ingredient to sort of tell us how much capital formation we will use, I am concerned about this business of where do we get the capital formation. Because if you create the demand ahead of the capital formation, and pressures come on the Congress to see that it is done, and if private enterprise is not moving possibly as rapidly as some think they should to develop that area, then the pressures are on the Congress to get the Federal Government to provide that capital, the needed capital formation.

I think it is very important in considering these various methods, or areas from whence we get capital formation, to include the Federal Government in the picture.

It is a big source because then we go on to these other areas of retained earnings in corporations, or the self-financing proposition and then our various legal reserves, depreciation, and other special tax differentials that do create a source of capital formation—I am thinking particularly just to illustrate, the corporation that buys up another corporation with tax losses, and so can help finance that proposition—borrowings from the bank or through issuance of funds, and then of course equity investment, and many of these differentials, as I see them, in our tax structure—we have got zero, 25 percent, 52 percent, and a 20- to 91-percent range, and this attempt to shift from one tax treatment from zero, or from the 25 to the zero or from the 52 to the 25 or from the 91 to the 25 creates all of these rather complicated problems that I see at any rate in what method of how we got the capital formation through one of these areas. Underlying it all is the fact that the Federal Government is using the tax structure to effect these economic results deliberately.

I might comment that I think any tax has an economic effect, but there are two approaches to writing the tax.

One is to produce revenue realizing that you are going to have some economic effect when you do it, and then trying to weigh what effect that is and whether it is good or bad. But the other thing I have seen in our tax thinking in the Ways and Means Committee for some time, is just to deliberately say, "We can produce an economic effect by doing this," ignoring the revenue use of the taxing power to do it.

This is not in the form of a question, unless anyone wants to comment.

The observation I wanted to make though, the Federal Government has taken the power to mess around with the dollar, to produce economic affects, and not maintain its use as a measuring stick. I think it is most essential if we are going to go ahead in our analysis of economic events, and occurrences, to have a measuring stick. We are guilty of attempting to produce economic effects with the dollar value and now we are doing something that I think is possibly equally dangerous, of taking the taxing power and using it not for revenue purposes but again to produce specific economic results.

I don't know whether it is good or bad but I think that is what has been happening. I think it is something that these papers in the panel series all point to but none of them have specifically said. As a group these are the deductions, but as a group they all conclude with that observation.

I would appreciate it if anyone would like to comment or disagree with those observations.

If no one cares to I am finished.

Mr. Mills. Senator Douglas will inquire.

Senator Douglas. I want to start off with two comments about points which my colleague from Missouri has made.

They do not require any comments from the panel unless they wish to give them.

The first deals with Congressman Curtis' argument, which as I understood it declared that, in view of the long-time increase in the price level, some differential treatment for capital gains as compared

with ordinary income could be justified as a means of compensating for the long-time shrinkage in the value of the dollar.

Mr. CURTIS. Senator, I was not justifying anything at all.

Senator DOUGLAS. You were making that as a comment?

Mr. CURTIS. I was making it as a comment. I was not trying to justify anything. I am trying to find out.

Senator DOUGLAS. I though it was used as an arguing point for different treatment for capital gains as compared with ordinary income.

Mr. CURTIS. I am not trying to argue any point.

Senator DOUGLAS. All right.

At least, this is sometimes used as an argument.

Mr. CURTIS. Yes. I will try to bring out some points for argument.

Senator DOUGLAS. I don't want to make this a personal discussion between us and I will simply treat this argument if I may: It is perfectly true that the long-time changes in the value of the dollar caused by fluctuations in the general price level have very disturbing and inequitable results upon various groups, including investors, but the point Mr. Heller made in his paper on page 392, which I think is appropriate in this connection, namely, that we have had relative stability of the general price levels since March of 1951. It is true that this has been obtained by disparate but relatively countervailing movement in the prices of farm products as compared to nonfarm products but the general combining price level of consumer and wholesale prices has been relatively stable since 1951.

We therefore can say we have had nearly stable prices for 5 years.

Yet it is during this period, particularly the period from September 1953 to September of 1955, that we have had this extraordinary increase in the stock market prices. It is an increase, probably, of somewhere around 70 percent. It is an increase in absolute values, as Mr. Heller points out, of $75 billion, so that for capital gains—so-called capital gains—which may have been realized during this period, the differential rate of taxation cannot be justified on grounds of inflation.

When I say "realized during this period," of course I mean on purchases made earlier, in the same general period and in sales made later within the same period.

That is my first comment.

I hope the Congressman will forgive me if I make a second point and comment on his statement that he regarded the capital-gains tax as differential rather than preferential, because, as I understand his argument, that while it may be differential between classes, it is not preferential between individuals, since each individual has the right to enter this particular class.

Now I hope the Congressman will not take offense if I quote a passage from Anatole France in reply to this. As I remember Anatole France's novel—The Red Lily—there is a passage in it in which he speaks of the majestic equality of the laws. He says the laws have majesty in their equality because they forbid the rich as well as the poor from sleeping under bridges and begging in the streets for bread, and if any rich man would dare to sleep under a bridge in Paris or beg in the streets for bread he would be arrested just as the poor man would be. Therefore the law, said Anatole France, treats all of these equally.

Similarly it can be said that if a man with very low income wants to invest in common stock he is perfectly free to do so, and it would be granted to him but, lacking the economic means to purchase the common stock, or desiring, if he does have a little money, or wanting security rather than appreciation of principle, this possibility as a practical matter is not open to him.

Mr. CURTIS. Thrift is open to any individual.

Senator DOUGLAS. Legally open.

Mr. CURTIS. And actually open.

Senator DOUGLAS. I do not quite see how people with low income and no real surplus of income over the current expense or expenditures can be expected to be large investors in capital assets.

Mr. Heller?

Mr. HELLER. Senator Douglas, one could push that very point even further and note that the preference really is not available to all on the same terms. In the lower brackets, the capital-gains rate is half of the normal tax, but in the top brackets, 25 percent is a good deal less than half of 70, 80, or 91 percent. That is definitely a preferential differentiation, or a differential preference.

Mr. CURTIS. You mean because it does not go up in accordance with the other?

Mr. HELLER. Yes. The higher income individual gets a much greater proportionate cut in his tax on capital gains than the lower income individual.

Mr. CURTIS. You assume the other is not preferential the other way. You start out with a preferential against the higher income bracket taxpayer.

What you are saying is it is not much against him. It all starts from that point that you have already taxed him more.

Senator DOUGLAS. I wonder if I might address a question, particularly to Dr. Shoup, but possibly to others as well? As I remember your writing, Dr. Shoup, you have done a good deal of work in the comparison of national tax systems and tax structures.

Mr. SHOUP. Yes.

Senator DOUGLAS. I wanted to ask you some questions, if I might, or at least a general question about the British system, which, as I understand it, has no capital-gains tax at all. In general what I am trying to get at is how wide is the British definition of capital gains and to what degree do the various types of capital gains or income in England which are given preferential or differential treatment in the United States, fall into two classes? That is, to what degree are they exempt from all taxation or pay no taxes at all, and hence fare better than they would in the United States, and to what extent are they taxed at the British income-tax rate, which is, of course, higher than the American?

I have never been able to get a very clear answer to that from casual questions which I have addressed, and I would appreciate any light you can throw on it.

Mr. SHOUP. My understanding of the British laws, as interpreted by the British courts, is that, as we would view it, they do not tax capital gains. On the other hand, it is true that transactions which might appear to us as rather isolated, once-for-all transactions in purchasing assets of a business, or something like that, and reselling, have been held by the British courts to be income on the grounds

that this was in the course of, as we should say, doing business, so it seems to depend upon whether this thing that you buy and sell is to be regarded as an object of a business transaction in some general sense, or whether it is to be regarded as nonbusiness.

I am not an expert on the British law, but my impression is that, if I, for example, should buy the inventory of a liquidating company—the actual stock in trade—and then sell it at a profit, I might very well be held taxable under the full British rates as engaging in a bit of business, though rather isolated, to be sure; whereas here, even though inventory in a going business is not considered a capital asset, I might—here I defer to Mr. Surrey—be considered as engaging in a capital-gains transaction. From the point of view of investment in securities, we may say that the British do not tax capital gains at all, whereas we do, but at what I would call a preferential rate.

Senator DOUGLAS. What about realized appreciation for real estate?

Mr. SHOUP. As I understand, real estate is substantially the same thing, although, again, I am not expert enough to draw the line very clearly. My impression is that if I should buy a piece of real estate, a person in my position who is not in the real-estate business, and should some years later sell it at a profit, it might be difficult for the Inland Revenue to show that I was in business in that respect.

Now I want to add, while we are talking about this, that the recent report of the Royal Commission on the Taxation of Profits and Income, which has just been made public, presents the same two contrasting points of view that we find in this country. The majority opinion supports the existing British practice, and concludes that it would be unwise for Britain to extend the income tax to capital gains. A strong minority report, in which three members join, can see no reason for not extending the income-tax treatment to capital gains, with due allowance for such factors as bunching of income in a given year, and so forth.

Consequently, as things now stand, we may say in a rather general and rather rough way that the British prefer not to tax capital gains at all, although they do have a provision analogous to our old section 102, which attempts to prohibit undue accumulation of undistributed profits in the so-called controlled or we would say closely held companies. But they do nothing with respect to the big and large companies. However, the Federal law extends capital-gains treatment to many items—for instance, standing timber, livestock, profits of an inventor—which Great Britain taxes as ordinary income.

Now, again, I am not a lawyer and I would prefer to defer to my colleagues, particularly Mr. Surrey, on that point. Perhaps he would have something to add on the British system.

Senator DOUGLAS. Have you made a study of the comparative tax laws of Great Britain and the United States on this subject?

Mr. SURREY. I haven't done that——

Senator DOUGLAS. Sometimes these differences in definition suggest points of principle which help us in making decisions. I do not sweep aside comparative tax structure in trying to gain answers in these matters.

Mr. SURREY. I am interested in making that study and I am trying to lay the ground for it. I did do this, Senator: We happen to have at the Harvard Law School this year two visiting Canadian professors of taxation. By and large the Canadian courts tend to follow

the British courts in this matter. I went through all the situations in this country where we give capital-gain treatment and asked what would happen in Canada.

There is one difference that struck me as very interesting. I just put this simple question: What would be the tax result in Canada if I were to invest in unimproved real estate because I felt that in a few years this real estate would rise in value, and I could sell it at a profit—I am purely speculating in real estate and it is the only investment I ever made. These gentlemen told me that it was probable in Canada that I would be taxed on the profit on that real estate.

Senator DOUGLAS. As income?

Mr. SURREY. As income, because I was investing for a profit. I intended to make that profit and therefore it ought to be taxed. That, in a sense, is what we would regard as the purest kind of capital gain. That is what they may well regard as the clearest case for taxability.

Now, given that difference, it is difficult, therefore, to generalize as to what a particular foreign country does. I get the impression that the Canadians and the British tend to tax, if the gain, the capital gain is expected or directly sought, but do not tax if the gain is somewhat unexpected. In other words, you may invest in an asset and get a recurring profit from the asset. If there is also an appreciation in value, they will not tax that appreciation. But if you invest in an asset with the emphasis on just the appreciation in the asset, they tend to tax that appreciation, which is really just the opposite of what we do. They, in effect, may tax what we would say is the purest capital gain.

Senator DOUGLAS. That is in the case of real estate. Would that be as true in the case of securities?

Mr. SURREY. In the case of securities, if you are getting income annually, dividends, etc., here probably the Canadians nor the British would tax any incidental appreciation in value. If it happened to be a security in which you didn't expect any income at all, but were just investing for the appreciation, I don't know what they would do.

Also, there are stories emanating from Canada that the Canadian tax officials may be interested in applying the Canadian tax law to those people who are trading to a considerable extent on the stock exchange. That is, investors who are turning over their stocks very rapidly, who have a great many stockmarket transactions. The Canadian tax officials may attempt to tax these people on the ground that they are really in the business of investing. We would not in this country.

Senator DOUGLAS. Even though not brokers?

Mr. SURREY. Even though not brokers.

Senator DOUGLAS. What about professional speculators who are not listed on the London exchange?

Mr. SURREY. My impression in England is that they would not tax those people. The difficulty in all of this is that, in neither the English nor Canadian law, is there any attempt in the statutory law to define the term "capital gain." It rests entirely with the courts.

Senator DOUGLAS. They haven't been as precise as the American Congress, then?

Mr. SURREY. The British and Canadians have not made the heroic effort that the American Congress has.

Senator DOUGLAS. That is an indication of the superiority of the congressional system over the British parliamentary system.

Mr. SURREY. That is the difficulty with going through the British and Canadian materials. I might add that the Canadians are now beginning to experience all the problems that we are experiencing. Their tax system is beginning to break down in this area, and they have had to resort to statutory definition, to statutory provisions increasingly to prevent evasion as a result of their system of not taxing capital gains.

Senator DOUGLAS. We are interested in both growth and stability. It is sometimes said that we should give more liberal treatment to capital gains. It is said there should be a smaller rate of taxation and a shorter period in order to get greater growth. At times the argument is that this would provide greater stability in stock prices.

Yet Britain gives even more liberal treatment, apparently, of capital gains than we do; that is, no taxes at all, and this is not made up apparently by differences in definition.

What would you say about the comparative growth of Great Britain, as compared to the United States? Has this superior treatment in Great Britain led to Great Britain surpassing the United States in the rate of capital formation and stimulus to industry?

Mr. SHOUP. So far as the question is addressed to me, Senator Douglas, I would like to answer indirectly by saying that I believe the effects of taxation on these broad economic forces are much smaller, much lighter, than is commonly supposed, and that I should think it would be a fairly hopeless task to try to find in any comparison of the British growth with United States growth the extent to which differences in the tax system have been accountable for differences in the rate of growth. I simply wouldn't know how to go about making a study that would be even reasonably conclusive on that point; and we may put it another way: there is very little evidence, if any, that the British treatment of capital gains has resulted in any difference in rate of growth as compared with our treatment of capital gains.

Senator DOUGLAS. In other words, it has not given any tangible indication of speeding up their rate of growth of capital accumulations, despite the fact that the difference between the British rate of taxation of income and their rate of taxation of capital gains is infinite, or is greater than ours, which is 50 percent?

Mr. SHOUP. That is quite so. Of course, one may conclude that we have been in some sense growing faster than Britain, but even that wouldn't answer the question negatively. The question is one of comparison, what would the British have done had they had our capital-gains tax.

Senator DOUGLAS. Perhaps a fairer basis of comparison would be Canada, which is a new country, and which has had a rapid rate of capital formation and of expansion. I was wondering whether there is any evidence to indicate that the more liberal treatment of capital gains in Canada, as compared to the United States, has stimulated the rate of Canadian investment, as compared with American investment.

Mr. SHOUP. I don't know of any such evidence, Senator. Let us consider that, after all, our rate of capital-gains taxation is so light, compared with the magnitude of the gains that one expects from venturesome investments, that although we cannot say that our sys-

tem is a system of zero taxation, nevertheless it goes a long way in that direction.

Senator DOUGLAS. Mr. Butters, I believe you have done some studies on this question.

Mr. BUTTERS. I think, sir, the main conclusions from our studies are those which are summarized in my original statement. Our finding was that with respect to those individuals who have any inherent tendency to be willing to take sizable investment risks, by far the most important feature of the existing tax structure is the differential between the rate on ordinary income, and the rate on capital gains.

The large that differential is, the more attractive it is for a person who is inclined to gamble in an investment sense at all, to gamble in the direction of taking a large gain which will be taxed at a low rate. Logically, I suppose, one could infer the wider this differential is, the stronger this incentive will be. As a factual matter, on our findings, it seems to be quite strong at the present time for those groups of individuals who like to take risks.

On the other hand, for those groups who hesitate to take risks, and who worry more about losses than potential gains, the effects are likely to be just the opposite.

Senator DOUGLAS. I don't want to belabor the point, but I am a little puzzled by the experience in Britain because there the difference between taxation of ordinary income and zero taxation on capital gains is infinite. As I remember my mathematics, the difference between zero and any figure is infinite and certainly the British absolute rate of taxation is extremely high. Yet has this produced a venturesome attitude on the part of British investors? Are they characterized by wanting to go into venturesome activities? Do they depend upon an appreciation of their principal for their gains, or do they tend to play it rather safe, and think of income? This may be a difference of national psychology, but certainly I had not thought that the capital gains treatment in England had let to a greater investment in equities.

Mr. Heller?

Mr. HELLER. Well, I don't think we have any direct evidence that bears on it. We certainly don't have any evidence that is inconsistent with the point you are making. However, we ought to push this point about possible lowering of the capital-gains tax, or increasing the differential, one step further; namely, when does this tax lure to venturesome undertakings break off into greater speculation? We might well reach a point, possibly we have reached it already, where a good deal of our investment activity is devoted to the quick turnover for speculative profit.

The Wall Street Journal recently quoted Henry C. Alexander, president of the Morgan bank, as follows:

> The dangers inherent in a speculative world are difficult to overestimate. Excessive speculation, the nonproductive passing back and forth of assets at successively higher prices, diverts money and credit from the channels where they might be employed to produce real wealth. Thus it undermines the true basis of our economy, while erecting a flimsy superstructure of inflated prices.

I think that kind of thing puts a limit somewhere on lowering the tax to stimulate venturesome investment.

Senator DOUGLAS. Presumably on a lengthier period.

Mr. HELLER. Precisely.

Senator DOUGLAS. In other words, for a healthy society the attention of investors should be concentrated upon income, rather than upon appreciation of principal. Granted that there is always an urge to some speculation.

One further question. Mr. Chairman, have I used up my time?

Mr. MILLS. Go right ahead.

Senator DOUGLAS. One final question I should like to ask is addressed to Mr. Brown. I would like have you turn, if you would, to pages 368 and 369 of your paper. It is at the bottom of page 368. I thought your paper was very able, Mr. Brown, and I want to congratulate you upon the intellectual quality in it. It is addressed in the main to the so-called locked-in problem; that is, the alleged reluctance of an individual to change his investment because of tax consequences.

When we were holding the stock market hearings last winter, as I remember it, the New York Stock Exchange revealed a survey which it had conducted showing that for 70 percent of security holders, tax considerations were of no, or at best, moderate importance in their investment decisions. Do not these results suggest that the locked-in effect has been somewhat exaggerated?

Mr. BROWN. I think it is difficult to evaluate the extent to which it may have been exaggerated. I presume you mean exaggerated by columnists, in speeches, etc. To my mind it really is very important to try and have this level of capital formation in the next decade, and it is very important to try and finance it soundly. I am sure you are familiar with the fact that corporate debt, both short- and long-term corporate debt, is now at a level of over $200 billion; it was about $209 billion at the end of 1954.

This represents approximately 70 percent, for example, of our national income, using that as one standard. This may be compared with a level of debt in 1945, when it was about 55 percent of national income.

In the next decade, if we were to continue to finance our capital investment in the same manner, drawing from the same sources, including debt, of course, and retained earnings, corporate debt at that time, would be roughly equivalent to 80 percent of national income.

It would appear to be much sounder to try to utilize other methods of financing, primarily, of course, a larger level of new stock issues—at least $3 to $5 billion a year of new stock issues, if it could be achieved, Mr. William Martin, recently before the Senate Committee on Banking and Currency, pointed out that savings were today running somewhat behind, and if I may quote him: "Under prevailing conditions, demand for funds are running far ahead of the supply of savings." I believe he was referring primarily to housing credit at that time. Dr. Nadler, up in New York, just last week, I believe it was before the National Association of Mutual Savings Banks, pointed out that savings were lagging.

Consequently, I suggest that in terms of making available presently locked-in capital which can be transferred out of some of these large "blue chips," such as Du Pont and Standard of New Jersey, where the amount of unrealized capital appreciation today is at least 4 to 5 billion—if this money could be made more readily available to smaller corporations, to companies which are not yielding 3 and 4 percent, as many of our stocks are, but yielding much higher, it would help them, in turn, to finance capital expansion on a sound basis in the coming decade.

Senator DOUGLAS. I just want to take up one definition before I go on to allied questions. You say that the ratio of debt to stock issues has increased?

Mr. BROWN. Yes, sir.

Senator DOUGLAS. But if you took into account the internal investment of corporate earnings after taxes, would the ratio of debt to equity have changed?

Mr. BROWN. I think, generally speaking, it hasn't changed very much, due to this tremendous plowing back.

Senator DOUGLAS. I think that is the essential point. As I remember it, that is made relatively constant, about 75 percent of total.

Mr. BROWN. That is correct.

Senator DOUGLAS. That is in the form of equity.

Now, I want to go on to this illustration, if I may. This investor is considering a switch from a blue-chip holding, in this case Du Pont, to some other stock—perhaps a venture. He bought Du Pont, as you say, for $43.75 in June of 1949. It is now selling at the end of September for $219.75 and yielding 3 percent.

If he sells the Du Pont stock, his net proceeds after tax would be $21,975, minus $4,400, or $17,575. That is his net proceeds after taxes. Now, will he not be just as well off, in terms of current dividends, if he invests this amount in a stock yielding as little as 3.75 percent?

In fact, if my computations are correct, he would be just as well off if he invests the $17,575 in a venture-company stock, which he thinks will rise in price by as little as 25 percent, assuming that he expects the Du Pont stock to remain at its present price.

Even taking an extreme example like this, will the tax exert much influence on locking in the investor to the Du Pont holdings if he can find some other investment even slightly more attractive in terms either of yield or appreciation of principal? Doesn't this type of arithmetic, namely, the question of what would happen to his investment if made alternatively, as it will be, throw some light on the question as to whether the locked-in factor has been exaggerated? In other words, one should look back at the stock which he now holds, compared with the price at which he purchased it and the price which he can now realize.

Should one not also look forward into what he can invest the net profit? If the yield percentage is 25 percent higher, or if the appreciation of principal is 25 percent higher, if my point is correct, it is worthwhile for him to make a sale. Therefore, hasn't this locked-in effect been exaggerated, with good motives, I am sure, but hasn't it been exaggerated?

Mr. BROWN. I assume, Senator Douglas, your arithmetic is correct. I think it is approximately correct. I haven't figured it out, but, of course, in any decisions to transfer investment funds from one stock to the other there is not only the strict logic of it, but there is the problem of all the tangibles and intangibles that are involved in making that decision. In other words, you can't be sure that you are going to get a yield of 3.75 percent; you can't be sure you are going to have this appreciation of capital which you mentioned. You have got a psychological barrier, it seems to me, frankly, paying the immediate tax that would be involved on the gain, and you have a problem here which I think is both a matter of making your best estimate as to

what the new venture would return, as well the psychological block that is involved in paying the tax.

We have the problem here where the tax is not withheld, for example, which is a factor in the case of ordinary income taxes, and I would think that for Mr. Jones to realize he is going to have to pay $4,400 in immediate tax payment, or at the end of the year, depending on the filing date, would be a fairly substantial restriction on his desire to get out of Du Pont into something else.

Certainly many of the people in our industry feel, as you know, very strongly that it is a very restrictive influence and a very hampering influence in trying to persuade people that when they have something they think is a better investment to transfer the capital from that investment to another one.

Senator DOUGLAS. Do you refer to the stock exchange?

Mr. BROWN. I refer to the securities industry.

Senator DOUGLAS. Naturally, I am not indicting the stock exchange. Naturally, they want a large activity and big turnover of stock because their members get a commission on each share. I am not attacking you for that, I merely mean to say that they are human beings, whose judgments are somewhat affected by economics. In this they would not be unusual or in no sense are to be blamed, but perhaps it might explain their attitude.

There is one final point I will make, and then I will stop, Mr. Chairman. It is perfectly true that the owner of the shares will have to consider what is going to happen to the new company. That is true. But every such decision involves that, and it also involves a comparison of the new investment with the old.

It may well be that what the investor should do is to hold on to Du Pont; Du Pont may go up more than 25 percent above the 220 figure which it had at the end of September. I suppose it may, because I don't believe all losses on September 24 would be made good by September 30, so that perhaps what he should do is to hold on to Du Pont.

I will stop there. Now, Mr. Chairman, these are the only questions that I feel I should ask. I regret that I must leave in 10 minutes. Before I do that, I want to express my appreciation to all the members of the panel, without exception, for the extremely high quality of the papers which they have produced and for their public spirit in coming down to testify.

Mr. MILLS. Senator Goldwater will inquire.

Senator GOLDWATER. Mr. Surrey, to get back to the definition of capital gains in the questions that we talked of earlier, the 16th amendment says:

> Congress shall have power to lay and collect taxes on incomes from whatever source derived.

If we look at the initial description of income by the court, they say:

> Gained, derived from capital, labor, or from both combined, inclusive of the profit, gain or sale or conversion of capital assets.

Now, all taxes that we pay are paid from income.

What would be wrong with the approach of calling all income profit and doing away with the idea that we have a capital gain and a profit, when in effect both are profits, and putting on that one definition a graduated system of taxation?

Mr. SURREY. If I understand your question, Senator, it is saying that we should not have a distinction between capital gains or income, but that we simply should have a tax on income and included in income is the gain that a person makes on investments.

Senator GOLDWATER. It is not a suggestion. It is merely something to hear your opinion on.

Mr. SURREY. I think that takes us back to Congressman Mill's opening question.

You would have to, I think, do one thing, and that is, if I understand the direction in which you want to comment, you might have to do something about the averaging aspect. We have a progressive rate structure and it makes quite a difference under it whether you happen to have your profit spread over a number of years or realize it all in 1 year. I think, therefore, that averaging of capital gain would be necessary under your proposal.

I think your question then is, assuming averaging, would there be any adverse impact upon the economy as a whole if we were to tax capital gains as ordinary income.

As I understand the comments of the other gentlemen around the table, some of them feel that with present high rates of tax, that is, individual income-tax rates going to 91 percent, subjecting capital gains to full taxation as any other income would have an adverse effect upon the economy. If the present high rates of tax, individual tax, were reduced, which I gather everyone on this panel would favor—for different reasons probably, but would favor—say, to something like a top rate of 65 percent, your question becomes much more difficult to answer. Then you would be asking, given a regular rate of tax not going higher than 65 percent, would there be an adverse effect upon the economy if capital gains were taxed as ordinary income?

My general impression would be that you could at least raise the capital-gain rate probably to something around 45 percent or so at this stage, and that would probably not have an adverse effect, all things being considered.

To the extent you lower the high rates of tax on ordinary income, you make investment more attractive, because a person can retain more out of his dividends than he formerly could at the 91-percent rate. So that if you were to lower the high rates of tax to about 65 percent, you might well raise the capital-gain rate to at least 45 percent, and I suppose some economists would say you could even raise it to the regular 65-percent rate.

Senator GOLDWATER. Does anybody else want to comment on that thought?

Mind you, it is not a proposal, it is merely a thought.

Mr. SHOUP. I believe that the idea brought forward by Senator Goldwater is, in effect, the only way that we will ever get out of the present dilemma.

There is one further element in this situation. If, at the same time capital gains were taxed as ordinary income, along with some averaging device, the corporation rate were also lowered, then I think it is quite likely that the combined effect of a lower top income-tax rate, a lower corporation income-tax rate, and treatment of capital gains as ordinary income, subject to averaging, would not exercise an appreciably hampering effect upon our economy.

I agree with Mr. Surrey, that as long as we try to distinguish something called capital gains from something else, we will be faced with a definitional problem that is in a sense insoluable. It is not new in taxation, of course. Suppose we wanted for some reason or other—I make this purely an imaginary case which, of course, nobody would support—suppose we wanted to tax wages at half the rate of salaries. One can imagine the problem of definition.

We have had problems similar to this in the excise taxes, in taxing fur coats. What is a fur coat? The hearings are full of problems on those points; there is no escape from the definitional problem. There are only two possibilities. One is to lessen the problem by lessening the rate differential. The second is to abandon the distinction completely and make a tax system that is consistent within itself, and not unduly repressive on any sector of the economy.

May I add one further point, because all of this has to be viewed I believe on the grand scale.

So long as the exemption of issues of State and local bonds continues, we have still another pull away from the kind of investment that we now attempt to lure people to by a differential capital-gains rate.

If then, along with a lower corporate rate, lower top surtax rates, and abolition of the exemption on future issues of State and local bonds, we had treatment of capital gains as ordinary income, I believe we would have a quite workable tax system.

Mr. HELLER. Senator, I would add one thing to that, and I think that Mr. Shoup would accept it; namely, that we have to combine with all this a provision for constructive realization of capital gains at the time of transfer by death or gift, because if we left that hole open——

Mr. SHOUP. It would be essential to close that loophole.

Mr. HELLER. Then of course, we would negate this attempt to bring the two things into harmony as you are suggesting. Even if we should not take any other action, one of the most disturbing features in the capital-gains structure from the standpoint of the drag on investment, let alone the problem of equity, is this big escape hatch we open up and say, "Here, you can walk out this side door without paying tax if you hold onto the property until you die." Or if you give it away, of course, you can defer the tax for a long time.

Then I want to add just one comment on this definitional problem. The feeling seems to be developing, either that we abandon completely the difference between capital gains and ordinary income, which we are not likely to do, or that there is no way out of the morass of our present definition.

I don't think that that is actually what people are trying to say, but a little of that flavor seems to have permeated the discussion. Certainly, there is some halfway house by which we could restrict or narrow the definition to prevent abuses, even though we can't perfect the definition legally or economically.

Senator GOLDWATER. Mr. Brown?

Mr. BROWN. I might suggest instead of having just one basket labeled "capital gains" and the other with everybody subject to ordinary income rates, you might consider having 5 or 10 baskets, each of them labeled different things, each of them carrying a different rate, or, as an alternative, may I suggest facetiously you might subject

everybody's income, by definition, to a capital-gains rate, then we can start all over again. [Laughter.]

Senator GOLDWATER. One of the reasons that prompted my thought is that as I sit here day after day listening to you gentlemen, I am impressed by the little attention that has been given to the complicated taxation system we have in this country and the restraining effect that it has upon small business in particular.

I think we should be constantly mindful of the morass that we are in with our tax laws. The thought came to me that this might be a method of simplification that would produce the same revenue, and eliminate loopholes that exist in both approaches, and would enable businessmen on all sides, particularly the little fellow, to better run his business and to better judge what his business can be from year to year.

The problem in small business today is not only the tax itself but the cost of paying the tax.

You find small businesses, with volumes of under a million dollars, that have to have men on their payroll who do nothing but figure out taxpayments, and, as someone suggested earlier today, the tax expert is always ahead of the Government.

We keep adding to our laws and failing to define our laws. I don't think the tax expert is ever going to be out of a job. He is an individual who has come into being of late. In fact, if I am not incorrect, I think the first income-tax expert developed about 1920 or 1921, and did it as a gamble. Since that time it has become a very lucrative and profitable business.

I find it very helpful in the course of the administration of my business. I don't want to see them out of work but at the same time I would like to see us doing something in this Congress to relieve the administrative burden of taxation.

That is what prompted my thought. With that, I suggest that we might tax ourselves to lunch.

Mr. MILLS. Yes; just 1 minute. Mr. Ture has some questions, but I wanted to get to the bottom of your suggestion if I could, Mr. Brown. I am intrigued. I assume you were very serious in the suggestion you made that all income might well be taxed at capital-gains rates.

Mr. BROWN. Well, I have read a substantial number of the papers in this excellent compendium that you have put together. I feel if there is any one thing that tended to pervade, it was the feeling that perhaps the ordinary income-tax rates were in many respects being perforated, and so drastically that there were very few people today that were paying the full income-tax progressivity that is reflected in our rates. Therefore, the thought occurred to me that perhaps we are in effect fooling ourselves and the American public by continuing these rates, and that a substantial solution to many of our tax problems would be brought about by getting rates down to a considerably lower level. I am referring, of course, even to the top-bracket rates.

Mr. MILLS. I thought perhaps you made the suggestion because you thought there might be equal economic justification for the application of the capital-gains rates to ordinary income.

Mr. BROWN. I am glad you asked me that because, of course, I do not feel that way at all. I was hoping, if we get the ordinary income-tax rates down to the level of capital-gains rates, we wouldn't have any tax at all on capital gains.

Mr. MILLS. Mr. Ture will inquire of the panel.

Mr. TURE. I would like to address this question to you, Professor Heller.

Suppose that we recognize that there is an inequity involved in taxing a gain on a capital asset which reflected merely an increase in the general price level—suppose also we recognize that this inequity called for some sort of revision, perhaps by the application of a general price index, to find out what the so-called real gain would be. Wouldn't considerations of equity require that we do the same thing with respect to all types of incomes, wages, salaries, interests, and everything else, that might generally be sensitive to general price level changes?

Mr. HELLER. Yes, Mr. Ture, I think that is absolutely right, it would. The problem would be one of just impossible complexity. By the same token, it seems to me that if you made a price level adjustment for capital gains, you would have to say that gains in the value of stock or real estate that didn't keep pace with the price level were actually a capital loss for tax purposes. You would be in the position of saying that if you bought a stock for $100 when the price level was 100 and now the price level has doubled but this stock has only gone up 50 percent you would be allowed a capital loss of $50 when you sold it for $150.

Mr. TURE. Suppose we could abstract from the administrative difficulties and complexities that this would involve—I wonder what the implications of a tax system which was based upon real changes in income, rather than changes as reflected in money terms, would be on our ability through fiscal policy to control inflationary or deflationary movements in the level of income.

Mr. HELLER. You have put your finger on a very basic point. That is, if we protect everyone from inflation in the structure of the income tax, we undermine the income tax as a weapon against inflation.

Mr. TURE. If, in fact, we would be protecting them at all. Whatever built-in stability we would have, or built-in stabilizing capacity we would have in an income tax such as the one we have now would be substantially vitiated by taxing on this basis.

Mr. HELLER. Yes; you could offset your undermining of the built-in stability by increasing the rates in inflation, and decreasing them in deflation, but I think that would be putting an impossible burden on the income tax.

Mr. TURE. I would like to address this question to you Professor Butters.

I noticed that you stated in your summary statement that investment capacity has been reduced by the progressive income tax, and that suggests to me that you consider it to be the progression in the individual income tax rates which primarily has had this tendency, though offset by other features of the law, toward reducing investment capacity of individuals.

I wonder whether you really mean the progression in rates, or the level of the rate structure?

In other words, suppose that over the course of the next decade, the rate of economic growth is such that we can and must substantially reduce the level of tax rates in order to assure full utilization of our

resources. Now, under those circumstances, do you think the problem that we discussed with respect to investment capacity, and the problem we discussed with respect to investment incentives would be as great as it is under present circumstances?

Mr. BUTTERS. I made my reference to progressivity with the fact in mind that the major portion of savings is made by private individuals in relatively high-income positions, and those individuals are paying high rates, higher rates than the average because of the progressive nature of taxes.

You are quite right in saying that it is the level of the tax rates in the income brackets where the saving takes place that is the significant fact.

Mr. TURE. Of course, we can substantially reduce progression as we commonly think of it in the individual income tax by broadening some of the upper rate brackets if we want to.

We wouldn't want to do that.

This would reduce progression but insofar as the broadening of the rate brackets was in the downward direction, more people would be subject to higher rates of tax at income levels that didn't change at all, so that presumably they would not be encountering a progression in the rate.

They would simply be encountering one given level of rates, which presumably might hit them very hard.

Mr. BUTTERS. In that circumstance it would certainly be the level rather than the degree of differences that is relevant.

Mr. TURE. On the whole, is it the consensus of the panel that with respect to this problem of having a differential between the effective burden on capital gains and on other types of income, that this problem would be substantially reduced if the process of economic growth makes it possible for us to have a lower level of tax rates in the future, or do you feel we might be better off in terms of stimulating investment to continue to provide a differential, a substantial differential, between the rate applicable to capital gains, and the rate applicable to ordinary income, even if we had a lower level of rates?

Mr. BUTTERS. If you are addressing that question to me, sir, I would say that for certain types of investments, the very venturesome categories, where the opportunities for appreciation are the greatest, the rate differential probably would give a larger degree of incentive than would a lower rate schedule with less differential.

I would not jump from that statement, however, to the conclusion that therefore the differential is desirable, because there are many categories of investment that are worthy of encouraging. Some of those fall in this very venturesome category, some do not. Those which do not would be more stimulated by a lower overall level of rates, and on grounds of equity and equality of the tax burden, certainly a smaller degree of differential in the rates would be desirable. I am look across the board rather than up and down and making that statement.

Mr. TURE. One final question, Mr. Chairman.

I think that we have, and correctly so, a basic bias in favor of the venturesome company. I think we are generally agreed this is a desirable thing. Our kind of society requires a high degree of venturesomeness in order to progress. I wonder whether when we try to

reflect this bias in the tax structure we will not provide disproportionate benefits to gains realized in the venturesome outlets, running the risk of encouraging a greater rate of investment in such outlets than reliance purely on the impersonal mechanism of the market would dictate, and therefore suggesting the best use of our resources is not being made.

In other words, perhaps there is an investment opportunity in a highly venturesome company. In the absence of the tax system, the economy as a whole, operating through the market, might conclude that by and large the chances of success for that company are not awfully good and perhaps this isn't the right way to use the scarce resources we have on hand.

Suppose we superimpose a tax system which says that if you will take a gamble on this, we will treat you much more lightly than if you restrict the use of your resources to somewhat less venturesome opportunities.

Do we necessarily have a net gain in this type of situation?

Mr. BUTTERS. I think what you suggest is a possibility. I think if I had to decide in which direction I was going to err on this point, I would rather err in the direction of too much rather than too little stimulus.

Mr. SHOUP. May I add one point on that?

We should not forget the deductibility of capital losses is in a sense an alternative to a differentially low rate on capital gains, and if we were to subject capital gains to regular rates, and were liberal in the allowance of capital losses, we would in effect be turning what would otherwise be risky investments into investments of fairly low risk, since in the case of loss, the Government shares the loss, in case of gain the Government shares the gain.

I realize that some of the Harvard studies have indicated that investors think less of the deductibility of losses than they do of the tax rate on gains, but perhaps that is because we have been so niggardly in our allowance of losses.

Mr. BUTTERS. I would certainly accept Dr. Shoup's statement, at least up to the point of saying that the more you loosen up the treatment of losses the more flexibility you have in the direction of taxing capital gains more heavily maintaining the same net balance.

Mr. BROWN. I would like to add that several members of this panel in their papers as well as several other people who have worked on this panel in other sections, mentioned this question of loss offsets; that capital gains was an important area in which by liberalizing the loss offsets, it might help substantially in solving the problem of getting more people interested in equity investments, in fact, more savings into equity investments, and I think that that certainly is a desirable area for Congress to consider.

Mr. MILLS. Permit the Chair again, on behalf of the subcommittee to thank each of you for your appearance this morning and contribution you have made to the study the subcommittee is undertaking.

The subcommittee will adjourn until 2 p. m.

(Whereupon, at 1:03 p. m., a recess was taken, the subcommittee to reconvene at 2 p. m. of the same day.)

AFTERNOON SESSION

The subcommittee met at 2 p. m., Hon. Wilbur D. Mills (chairman of the subcommittee) presiding.

Present: Senators Paul H. Douglas and Barry Goldwater and Representative Thomas B. Curtis.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The subcommittee will come to order, please.

This afternoon's session of the subcommittee on tax policy will be devoted to discussion of the impact of Federal taxation on natural-resource development.

As was announced this morning, our procedure is to hear from the panelists in the order in which their papers appear in the compendium. At the start of each of these sessions, panelists will be given 5 minutes to summarize their papers. We will hear from all panelists without interruption. The 5-minute rule will be adhered to.

Upon completion of the opening statements the subcommittee will question the panelists for the balance of the session. I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists, as well as answer the questions of the subcommittee.

Our first panelist this afternoon is Mr. Henry B. Fernald, of the firm of Loomis, Suffern & Fernald, New York City.

Mr. Fernald, you are recognized for 5 minutes.

Mr. FERNALD. Mr. Chairman and members of the subcommittee:

Determination of taxable income from mineral extraction is a distinctive problem. The mineral sold is part of the capital asset represented by the mineral deposit itself. The merchant or manufacturer purchases from others short-time supplies of goods or materials for sale or manufacture, pays for them only as received and found satisfactory and expects similarly to replace them.

In mining, exhausted mineral is not thus replaceable. Expenditures to find and develop other deposits are made without knowing what may result. Even mineral found may vary greatly in character and quality, in costs of production, and in market prices from year to year. Most mineral deposits found never repay the expenditures for them. Our tax laws recognize the distinctive mining problem, as they must do to tax fairly the income and not impair incentives for mineral production.

In a brief historical review, note is made of discovery depletion. early adopted, recognizing the mineral deposit as essentially capital the realization of which should not be taxed as if income. Because discovery depletion was difficult to apply, percentage depletion was adopted for oil and gas in 1926, for metal mines, coal, and sulfur in 1932, and later for other minerals.

In my paper I outline, as I cannot in this short summary, the present provisions particularly applicable to taxation of income from mineral extraction, especially cost and percentage depletion, exploration, and development; with some differences in application to oil and gas and to other minerals according to the peculiar conditions of each case, as is necessary to determine appropriately and tax fairly the income.

Also noted as important to mining are provisions regarding depreciation, losses, capital gains, and dividends.

As to economic effects, I note briefly a few points:

If changes in depletion or other tax allowances reduce incentives which are based on expected net return after taxes, we cannot assume, as some do, that activity, expenditures, and income will continue the same and greater taxes result.

Tax changes have their effect on mineral activities and search for and development of mineral resources, although with a timelag. Expectation for the future has major effect on incentives.

Taxes may impair but do not create hope for future profits. A right of deduction of present outlays or ultimate losses is ineffective except as the deduction falls against otherwise taxable income. Even if effective, tax reduction is only a percentage of the expenditure or loss, leaving the taxpayer still out of pocket for the balance.

Expenditures by mineral companies flow in continuing stream through payrolls, purchases, dividends, and otherwise, giving rise to taxes of others. A reduction in activities and expenditures by mineral companies may mean far more loss to the Government than the taxes against the companies themselves.

A reduction of mining expenditures seriously affects entire mining communities and extends across the country. Mining labor, investments, and expenditures do not readily shift to other lines and locations to maintain the same employment, flow of funds, and Government revenues.

Minerals in continuing supply are basic to our industrial and economic life as it exists and as we want it to be. Only with mineral products can human endeavor be applied most efficiently and productively for the needs and aspirations of the people. We may rightly acquire some minerals from abroad but should not be wholly dependent on foreign supplies which might be cut off or limited in war or in peace. We must maintain a vigorous, active, well-equipped and well-trained mineral industry available for emergency.

Determination of taxable income from mineral extraction is a distinctive problem for which our tax law makes special provisions. It also provides special treatment for other groups, activities, and many special problems. A single general rule cannot fairly be applied to all alike without regard to differences in circumstances and conditions.

In striving to improve tax provisions we should not make them less appropriate and fair, with undesirable economic effects on our mineral production and on the welfare of our people.

Mr. MILLS. Our next panelist is Mr. Horace M. Gray, professor of economics, University of Illinois. Mr. Gray, you are recognized for 5 minutes.

Mr. GRAY. During the past 30 years the depletion allowance has undergone a profound functional metamorphosis. It began, at a time when alternative institutional means were not available, as a modest, restricted form of privilege designed to promote the public interest in an area of immediate urgency. It has degenerated into a lucrative, generalized, and largely functionless subsidy the benefits of which accrue primarily to a few large corporations.

These benefits have in the course of time been capitalized until today they constitute a powerful vested interest, the capitalized value of which amounts to billions of dollars. This transformation—or insti-

tutional deterioration—is productive of many demonstrable evils but few, if any, public benefits. If percentage depletion ever served the public interest to an extent commensurate with its costs, it has long ceased to do so.

Under modern conditions the known evils so far outweigh the indeterminate and illusive benefits claimed for it that percentage depletion can no longer be defended on grounds of public, as distinct from private, interest. There is no necessary or urgent public interest at stake in the extractive industries which cannot be served better, more cheaply, and with fewer attendant evils by alternative means. If a free competitive price system will not call up adequate supplies of these minerals, and if a free capital market will not provide sufficient increments of new capital, then these deficiences can be met by direct, specific, governmental action without resort to a generalized tax subsidy divorced from performance.

Any plan of institutional readjustment that involves the elimination or reduction of percentage depletion will meet powerful opposition. That is to be expected, for such a long standing and lucrative privilege, involving large capitalized values and the economic expectations of many people, will be defended vigorously and tenaciously despite its functional obsolescence. Its defenders will portray with alarm the dire economic consequences predicted to ensue from its elimination or reduction, such as destruction of incentives, cessation of exploration, and development, scarcities, increased prices, foreign imports, retardation of investment, technological stagnation, shutdown of marginal properties, and impairment of national defense. Equally strenuous objection will be raised against proposed alternatives.

These efforts to identify private privilege with the public interest and to make it appear that the public welfare is dependent on continuation of percentage depletion are persuasive only if it is assumed that no alternatives are available or practicable. This assumption, however, is untenable; a free price system, a free capital market, international trade, and normal profit incentives, supplemented by direct governmental action in special situations, provide a readily available and socially desirable alternative.

The depletion allowance, in its present form, dates from the Revenue Act of 1926, when Congress granted to oil and gas producers the privilege of charging against net income in the computation of income tax liability an amount equal to 27½ percent of gross sales from crude production but not to exceed 50 percent of net income. This grant of privilege was justified on the ground that under the existing technological and economic conditions a stimulus was necessary to encourage the discovery and development of new oil and gas deposits. At the tax rates prevailing in 1926 a depletion allowance of 27½ percent did not appear to be an excessive price to pay for assurance of increased supplies and additional reserves. Furthermore, the tax savings loss of Federal revenue, it was thought, would not be significantly greater than those resulting from the system of cost depletion then operative. (Fernald, pp. 849–852, for historical summary 1913–54. Note particularly act of 1918, which recognized fair market value of deposit as the basis for depletion. This established recovery of the capitalized value of deposits, rather than recovery of actual outlays for discovery and development, as the basis for income-

tax computation, thus laying the foundation for the wasting asset and capital-gains arguments in defense of percentage depletion.)

During the subsequent 30 years, however, this restricted privilege, designed to serve the public interest, has been transmuted into a generalized tax immunity, or subsidy, which seriously depletes the public revenue, creates grave social injustices, and produces serious distortions in the economy. In short, the depletion allowance has become primarily a private tax-escape device the approximate effect of which is to equate the corporate income tax with the capital-gains tax in the natural-resource industries. This lucrative privilege constitutes a powerful vested interest, the capitalized value of which amounts to billions of dollars. For the defense and justification of this vested interest a sophisticated rationalization has been evolved to demonstrate that percentage depletion is a necessary, indispensable, and beneficial feature of our economy.

Ingenious arguments, which go far beyond the original purpose of stimulating exploration, are adduced to show that percentage depletion, as now authorized, is necessary to compensate for unusual risks, to facilitate capital formation, to protect small producers, to expand the extractive industries, to strengthen national defense, to sustain economic prosperity, to recomer the capitalized value of wasting assets, and to equate income with capital-gains taxation. The grand design of this rationalization is to reconcile private privilege with the public interest.

This transformation was inevitable, for in our society all privilege tends to be capitalized and Government cannot for long grant special privilege to some and deny it to others. The pressure is always toward the generalization and equalization of privileges. In the present instance, no sooner had the oil and gas industries been accorded the privilege of percentage depletion than other extractive industries began to clamor for equality of treatment. The 27½ percent depletion allowance became the goal to which all the rejected and excluded—even the lowly oyster-shell people—might aspire. With rising prices and higher income-tax rates the depletion allowance became increasingly lucrative and the capitalized value of its benefits (tax savings) correspondingly greater. Thus, the pressure to extend the privilege mounted until it became irresistible; Congress was forced to yield and gradually other extractive industries gained admission to the select company of the privileged, albeit at considerably lower rates. The Revenue Act of 1954 represented a crowning achievement in this long struggle, for the list of eligible minerals was extended to embrace almost the entire field and rates of depletion were increased substantially. The fact that these rates are still below the oil and gas rate is a source of continuing dissatisfaction and we find the President's Cabinet Committee in Minerals Policy, in its November 30, 1954, report, suggesting further tax concessions to eliminate deterrents to discovery and production (pp. 2 and 16)..

These developments have brought us to a point where the depletion allowance imposes on the Federal Treasury a huge loss of potential revenue the exact amount of which is not known but which may run to as much a $1 billion per year, of which amount the oil and gas industries account for approximately three-fourths. This deficiency must either be made good by nonprivileged taxpayers, or borne by

consumers through chronic inflation or by the general public in the form of desirable public services foregone. On the other hand, the public benefits derived from this tax concession to the owners of natural resources are indeterminate and extremely dubious.

It may well be doubted that these public benefits are commensurate with the social costs involved, such as misallocation of resources, aggravation of economic concentration, inequities in taxation, and impairment of the public finances. Whatever the balance of good versus evil inherent in the system, it seems clear that the time has come for Congress to ask some searching, critical questions about the depletion allowance and to explore carefully alternative means by which public purposes in the natural-resource area may be served without recourse to subsidization through tax immunity. In this inquiry the burden of proof should rest on the recipients and beneficiaries of special privilege to demonstrate that, on balance, percentage depletion actually serves the public welfare.

Among the question that should be asked are the following:

1. Is public subsidy, by percentage depletion or otherwise, actually necessary to call up sufficient supplies of mineral products? Why will not normal profit incentives and a free price system suffice to insure adequate supplies?

2. If subsidy is actually necessary on account of national-defense requirements would not some selective form of subsidy or direct public assistance, specific to given situations or needs, be superior to the generalized, nonspecific depletion allowance, achieving more certain results without the attendant disadvantages? For example, why not substitute for percentage depletion such direct aids as loans, purchase contracts, sharing of exploration expenses, stockpiling, publicly financed research, and premium prices for additional production?

3. Taking into account modern scientific methods, industrial organization and institutional devices for spreading risks, are the risks of exploration and development in the natural-resource industries actually greater or more onerous than in business enterprise generally? If they are greater in some degree why will not a somewhat higher return on capital, as determined in a free market, compensate for these additional risks?

4. Why should the Federal Government forego needed revenue in order to provide new increments of capital for the natural resource industries? Why cannot these industries, like other businesses, finance expansion by internal savings and by resorting to the public capital market without reliance on tax savings through percentage depletion?

5. What assurance is there that tax savings achieved through a generalized depletion allowance, with no performance requirements, will actually be used for exploration and development, technical improvements, conservation of resources or other beneficial purposes? In the absence of public control as to their ultimate disposition, may not such funds be diverted to other purposes quite unrelated to the development of natural resources?

6. If, as alleged by its proponents, percentage depletion does stimulate an abnormal (i. e., non-market-determined) flow of capital into the natural resource industries, does not this constitute a misallocation of economic resources, which lowers the overall efficiency of the economy, encourages the waste of natural resources, and reduces the level of general well-being?

7. Why should any attempt be made, through percentage depletion or otherwise, to place the natural resource industries on a capital gains basis of taxation? Why should they not pay income taxes at regularly prescribed rates like other business? What is peculiar or unique, in an economic as distinct from a physical sense, about wasting assets that entitles them to preferential treatment approximating capital gains taxation?

8. Why, in the natural-resource industries, should the captialized value of mineral deposits be treated as a wasting asset subject to depletion for income-tax purposes when in all other business only capital outlays, or actual investment, are depreciated against net income? In short, why use capitalized values in the first and captial investment in the second instance as the basis for computation of income-tax liability?

9. Do not the two privileges of charging intangible developmental costs against net income and averaging net income through the carry-back and carry-forward provisions adequately compensate for any unusual risks or hazards associated with exploration and development? Why is percentage depletion necessary as an additional incentive?

10. Given the existing degree of economic concentration in certain branches of the natural-resource industries, with its attendant consequences in respect to production and market controls and price and profit maximization, does not the major proportion of the subsidy represented by percentage depletion accrue to large firms, thereby aggravating the trend toward concentration of economic power and jeopardizing further the viability of competition? Is not the Federal Government by this device actually promoting monopoly and destroying competition?

Mr. Mills. Our next panelist is Mr. Arnold C. Harberger, professor of economics, University of Chicago.

Professor Harberger.

Mr. Harberger. In the paper which I prepared and submitted to this subcommittee, I showed how our tax treatment of mineral industries works to produce some combination of three effects: (1) It fosters an excessive use of resources in mineral exploration; (2) it gives mineral holdings an artificially high value.

To put it another way, if we were to revise our taxing of corporate income so as to treat all industries more equally than we now do, we would have less exploration for minerals and a smaller mineral industry, and lower values attached to present mineral holdings.

I shall here try to recapitulate only one phase of my argument: that connected with mineral exploration. It has often been argued that we want a lot of exploration, but I do not think that many people have stopped to realize the great magnitude of the wastes involved in our present scheme of incentives.

Take the case of petroleum exploration, where investment is estimated at around $3 billion per year. And for a moment, pretend that our percentage depletion provisions did not exist. Because most of the costs of petroleum exploration can be expensed against ordinary income, they would be shared by the Government to the tune of 52 percent.

But when the exploration was successful, companies could sell the wells they found, and pay capital-gains taxes on the returns they got.

Since direct expenses of finding successful wells are only a small fraction of the value of such wells, and since most of these costs can in any case be written off against other income under our present provisions, the sale of successful wells for capital gains would yield taxes amounting to around 25 percent of the sale value of such wells.

Our picture, then, is one of the costs of oil exploration being shared by the Government to the tune of around 50 percent, while the returns to exploration are shared only to the tune of around 25 percent.

Let us now conceive of an "income statement" covering all of the petroleum explorations of the entire economy. On the one side we have the costs of exploration, which, let us say, amount to about $3 billion a year. On account of these expenses, the industry pays less taxes to the amount of $1.5 billion a year.

On the other side, we have the returns to exploration, the market value of the oil found. Now, I don't know what this side would work out to be under the kind of tax setup I'm assuming. But either way the result is frightening. If the returns to exploration equaled $3 billion, the capital gains taxes on this would be $0.75 billion, and the industry as a whole would have profited to the tune of $0.75 billion from having spent $3 billion to find $3 billion worth of oil.

I feel our economy is much too competitive for this to happen. It is more likely that exploration would be pressed to the point where it paid off a rate of return after taxes roughly equal to the rate earned on other uses of capital in the economy. That is, costs after tax offsets would equal returns after taxes, when both were discounted to a single point in time at the going rate of return. If this were the case, that is, if oil exploration were a competitive activity as I believe it is, the industry would be pushing exploration so far, because of its tax advantages, that the expenditure of $3 billion would result in the finding of only $2 billion worth of oil. Net of tax offsets the industry would have laid out $1.5 billion, and after paying capital gains taxes on its $2 billion of receipts it would get back its $1.5 billion plus "interest" at the going rate of return to capital.

Now, spending $3 billion to find only $2 billion worth of oil is a very inefficient operation, and the more to be deplored because those who do the spending would still be getting the ordinary rate of return on capital and would have no cause to regret the outcome.

Our present tax setup is still worse than this, however. Percentage depletion was designed as a way of allowing the discoverers of oil to retain their finds and operate them without selling them as capital gains. It thus functions as a means of avoiding the capital gains tax altogether. Under this system, which I treat in more detail in my printed paper, if the industry spends $3 billion a year on exploration, it is making the ordinary rate of return on capital when it finds only $1.5 billion worth of oil.

This state of affairs can be remedied by gradually reducing and ultimately eliminating the provisions for percentage depletion, and by at the same time bringing the rate of tax on capital gains into line with the rate of tax on ordinary income.

It is not too farfetched to imagine the corporate income tax rate being reduced over the years to 35 percent, the percentage depletion provisions repealed, and the capital gains rate held at 25 percent.

This combination of measures would eliminate nearly all of the ill effects I have described.

Mr. MILLS. Our next panelist is Mr. Scott C. Lambert, general tax counsel, Standard Oil Company of California.

Mr. Lambert, you are recognized for 5 minutes.

Mr. LAMBERT. Percentage depletion and the national interest: 50 billion barrels of oil, almost double the known reserves of the United States, will be required by the ever-expanding needs of industry and the military of our country in the next 15 years. At the staggering rate of consumption of known reserves of oil, new discoveries and developments are an absolute essential if the needs of the future are to be met.

The demand for other minerals has likewise greatly increased with the growth of our country. What I have to say concerning the importance of percentage depletion to the oil industry will apply generally to other extractive industries as well.

Congress recognized after the First World War that if our rapidly dwindling petroleum reserves were to be replaced, fair and just principles of taxation must be applied to the industry.

In 1918 Congress saw the need for appropriate capital recovery allowances in the petroleum industry and enacted the discovery depletion laws, but like many things first tried, administration of this law proved difficult, full of complexities and controversy. Congress, without abandoning the principle, looked for a simpler method, and after long study by the Treasury and Congress the percentage-depletion idea evolved as a replacement for the old complex method.

Since the principle was enacted 30 years ago the merits of percentage depletion have been debated time and again in Congress, and reenacted time and again by both Democratic Congresses and Republican Congresses. In fact, Congress has today widened its application to nearly every extractive industry, evidence of the soundness of the principle.

Despite the long record of congressional and public refutation of their charges, critics of the principle continue to press the attack.

Their clamor not only obscures the truth that this allowance is fair, but further that it is vital to the future of the oil industry and the Nation.

Today, oil is many times more difficult, as well as costly, to find than it was when percentage depletion was first established. Yet, our industry has met every demand, both in peace and war. Leaders in Government and industry will tell you that the equity provided by the percentage depletion allowances of our tax laws has been a big part of this achievement.

And with it all, our industry has not prospered any more than other industries. This fact has been adequately demonstrated by a study of annual reports published by business concerns.

Many feel that the argument should end right there. The depletion allowance stands in principle on its own merits. Nevertheless it would be unrealistic to ignore the consequences of a possible depletion law revision that would put a check on the oil producers of our country. There would be far more at stake than an injustice to the members of one industry. There would be a real threat to the economic and military security of the United States.

Our economy and our security depend on oil. We cannot get along without it. Every year we consume an ocean of oil and more has to be found to replenish our supply.

But search for oil is an increasingly costly gamble. The wildcatter's position is a precarious one. Statistics show that during the 8 years following 1945, 40,460 new field wildcat wells were drilled—and that 4,525 were producers.

In other words, 1 well out of 9 drilled found oil, and of these, only 1 in 44 discovered a major field. If there is to be exploration, there economy runs on. The wildcatter who drills for oil and drilly 8 dry holes has to have some assurance that if he does find oil in the ninth well, he will be allowed to keep a fair profit, enough to keep him searching for more oil. If we cut off this incentive, if we discriminate against the oil producers, we are going to discourage the exploration which is necessary to replace our depleting reserves.

Discouraging exploration will not only diminish the new discoveries we must make but it will disrupt the highly specialized exploration organizations of geologist, geophysicists, and other scientists, which take many years to develop. This won't be something we can just fix up when we find that cutting down the depletion allowance wasn't such a good idea after all. Once the damage is done it will take a long time to repair.

Many years of sound taxing provisions helped to build a strong peacetime mineral industry which was able to provide the sinews of war when needed. This experience has shown the need and the way to protect our security in the future by assuring a strong industry and adequate available mineral resources.

In peace and war, the Federal taxing provisions relating to minerals have rendered a service that is testimony to the wisdom and foresight of the Congress that adopted the provisions in 1926 and has repeatedly fought down ill-advised attacks upon them ever since.

Mr. Mills. Our next panelist is Mr. James R. Nelson, professor of economics, Amherst College.

Mr. Nelson, you are recognized for 5 minutes.

Mr. Nelson. A wealthy economy may or may not have a greater national security problem than a poor one, but the wealthy economy is in a better position to protect itself if it so desires. This protection creates no special problems in addition to the general ones of collecting taxes and forestalling inflation except for the necessity for insurance against emergencies.

Emergencies, in turn, create special economic difficulties only if they greatly stimulate demands for certain goods or services, or greatly reduce the supply of these goods or services. These possible problems are best met, in general, by greater peacetime prosperity, which increases the margin of dispensable or postponable consumption and of leisure time which may be diverted to emergency uses if necessary.

Thus special treatment of a particular industry on security grounds must be justified by demand and supply peculiarities: Even an enormous increase in emergency requirements creates no special problem if supply can also be increased easily and rapidly, or large segments of normal consumption eliminated without extreme hardship.

Proof of the necessity for special treatment does not establish a case for any particular kind of special treatment. In some instances, special measures to expand the peacetime use of a product might be desirable, if this would result in the development of more capacity

and greater skills which could be easily transferred to meeting emergency demands.

Conversely, industries founded upon wasting assets would seem to be candidates for special restriction in peacetime, since their product cannot be replaced and use therefore subtracts from the total supply.

If domestic or imported supplies of the wasting assets can be stockpiled, at reasonable cost, as is the case with many metals and some other minerals, then encouragement of production may be combined with restraints on consumption by Government intervention to bid up the price and stockpile the resultant surplus.

If the asset cannot be stockpiled, then production should be stimulated only if this stimulus is a byproduct of the creation of available reserves, and if the discovery of new reserves is fraught with exceptional risk or might prove to be unduly time consuming during an emergency.

The distinctions relate to the industries subject to percentage depletion in the following ways:

(1) Petroleum and natural gas are by far the most important products of the extractive industries, and are legally allowed the highest rate of percentage depletion.

Petroleum apparently cannot be stockpiled except in the form of reserves left in place below the ground. It is completely exhausted in most uses, and may present a discovery problem. Crude-oil prices do not move freely; hence stimuli to production may not be matched by increases in consumption.

(2) Coal, the other important energy product of the extractive industries, presents no important discovery problems and is likewise completely exhausted in use.

(3) Metallics often involve discovery problems, but may present still greater difficulties in periods of low demand due to the specialized nature of productive factors and the possibility that discontinuance of production at one mine may add to the difficulty of later recovery.

(4) Nonmetallics are extremely diverse, ranging from products of limited usefulness in an emergency through highly strategic commodities, and from widespread and abundant known supply sources to isolated and meager reserves.

In general, the discovery problem for the important nonmetallics is minor.

The effect of percentage depletion on these industries also differs with the technique of extraction. Percentage depletion is available to all producers of petroleum as well as to holders of royalty interest in this production.

Since percentage depletion is a deduction from gross income, it provides a direct stimulus to production and not to the accumulation of reserves.

If property rights are in different hands, percentage depletion provides an incentive to drill wells into known oil pools. In connection with State output controls, this may increase surplus capacity immediately available, but only at the cost of duplication of investment and either nonrecovery of some oil or higher costs of eventual recovery.

This duplication is not an important problem in mining. Here the difficulty is that percentage depletion is not helpful in periods

of low demand, because it can yield no benefits unless the enterprise is making profits before depletion. Since stockpiling is an alternative, the question then becomes whether a tax method which gives some net stimulus to the discovery and development of new supply sources is preferable to a direct purchase program which both widens the market for new sources and encourages the continuance of output from known reserves.

For coal and most nonmetallic minerals, the effect of percentage depletion is probably in the main to increase the disparity between more and less profitable mines. It may, in addition, tend to increase production capacity and thereby either force down prices or add to the idle resources attached to the industry.

In the special case of sulfur, very little of the depletion allowance has been used over the years for exploration. Hence, it would appear that the allowance should either be discontinued or tied to exploration expense.

Finally, the problem of risk in the extractive industries deserves careful examination. Discovery risk is high for an individual wildcat oil well but it may be quite low on the average for a large concern drilling many wildcat wells per year.

Conversely, many normal business risks are lower or even nonexistent in the production of crude petroleum: The price structure is stable, the crude product requires no gamble on advertising or sales effort, fluctuations in labor, or other costs have little influence once drilling is completed until the stripper stage is reached.

Industry sopkesman who have cited long-run expansion of the industry in spite of returns averaging below those earned in manufacturing seem to support the view that risk is either subnormal in petroleum, or abnormally attractive to investors.

Mr. MILLS. Our next panelist is Mr. Lowell Stanley, director, Monterey Oil Co., Beverly Hills, Calif.

Mr. STANLEY. Mr. Chairman, members of the subcommittee, production and development of natural resources are basic and vital to our economy, and are recognized as essential to the growth, stability, and security of the Nation. The United States has had a leading role in development of most such resources, which has come under conditions of private ownership of operation, a capable, energetic and resourceful people, and tax laws which have permitted and in some cases encouraged such development.

Natural resources industries are particularly sensitive to the effects of taxation, because in a way different from other economic activities, capital or property itself is depleted in the process of extracting and producing minerals, timber, and the energy resources. Any effort at scientific taxation must take into account the nature and characteristics of the business to be taxed.

When the income-tax law became effective, fair market value of all property was recognized, and for the extractive industries depletion on, or recovery of, such value was allowed. Operators who later discovered or developed properties were, however, discriminated against. The disposition through production of their mineral resources was taxed as income, while their neighbors or competitors had a realistic allowance for the exhaustion of their capital values.

Congress found that this tended seriously to retard oil and mineral development, and therefore in 1918 recognized depletion based on discovery value.

After several years of administrative complexities the Treasury requested, and Congress after careful study, adopted for oil and gas the percentage formula in effect today. This practical and workable formula was later applied to mines in lieu of discovery value, and is now provided for all minerals.

The Supreme Court said—

> The granting of an arbitrary deduction, in the interests of convenience, of a percentage of the gross income derived from the severance of oil and gas, merely emphasizes the underlying theory of the allowance as a tax-free return of the capital consumed in the production of gross income through severance.

The fifth circuit court said—

> The depletion allowance was intended to encourage production, and may be regarded as a substitute for the capital-gains allowance where the taxpayer, instead of selling, leases or operates his own mineral holdings.

This concept was clearly applied by Congress in 1943 in changing the treatment of proceeds received from the cutting of timber. The Senate Finance Committee reported—

> The law discriminates against taxpayers who dispose of timber by cutting it as compared with those who sell timber outright. The income realized from the cutting of timber is now taxed as ordinary income at full income and excess-profits tax rates and not at capital-gain rates. In short, if the taxpayer cuts his own timber, he loses the benefit of the capital-gain rate which applies when he sells the same timber outright to another.

Without the depletion provisions, the same or even more serious conditions would quickly arise in the mineral and petroleum industries.

Most independent operators would, without laws which recognize such extraction or sale of property, ton by ton or barrrel by barrel, not only lack resources for development and exploration, but also be driven by the tax laws to sell their properties outright, and leave operations to new purchasers who would then be entitled to new cost depletion which would approximate, and in many cases substantially exceed, the amount of percentage depletion now available to the original holder.

Such a program, which would tend to force through taxation the sellout of smaller mineral and oil producers, is presumably against public policy, could have serious antitrust implications, and the Treasury would gain no revenue.

The percentage basis for depletion has, on a broad scale, the effect of the last-in, first-out (LIFO) method of taxation, where a taxpayer may deduct as a charge against operations his current cost of replacing inventories sold in lieu of the original cost. Natural resources are seldom replaceable today at as low a cost as the amounts allowed as percentage depletion, which however accomplishes at least a significant portion of what LIFO is intended to do for other taxpayers.

Seldom emphasized is the fact that about 90 percent of depletion of operators is that allowed to companies. When their earnings are in turn distributed to shareholders, such payments are taxed again, this time as ordinary income, without recognition of the depletable nature of the underlying properties. And except as it permits a

rotation or use of capital in the hands of the corporation, largely for the public interest, no direct benefit flows through to the stockholder.

A table in my paper illustrates the impact of such taxation. It illustrates the confiscatory results if percentage depletion were not allowed to the operator in the first step of taxation, and points to the conclusion that any adverse change in the allowance would precipitate liquidations and sales by independent producers on a much greater scale, create the risk of immobilizing or removing vital personnel and resources for exploration an development, create grave instability and hinder economic growth.

Sometimes referred to as an incentive, the present depletion law does in reality only bring such taxation toward a neutral position, and does not deprive producers of their natural incentive, as well as the opportunity, to engage or continue in the production of natural resources.

In the search for oil and gas, the expensing of geological and geophysical exploration programs and related activity is extremely limited under tedious and complex rules. An awkward and almost disheartening situation has developed in the application of these rules to these important modern techniques, and administrative costs and problems for producer and the Treasury seem to require some better solution. I urge that immediate steps be taken to permit the deduction in the year paid or incurred of all geological and geophysical expense.

In conclusion, percentage depletion at rates now provided in the law recognizes and approximates the capital values of producing properties, and is representative of the value created through discovery. Protection of such capital value is essential if independent operators are to continue to risk funds in discovering or developing the resources they produce.

Only with laws which recognize the fundamental nature of the resources industries will the impact of Federal taxation permit their continued vitality and development, which is basic to the welfare of our national economy, our defense, and our continuing progress.

Mr. Mills. The next panelist is Mr. Arthur A. Smith, vice president, First National Bank in Dallas, Dallas, Tex.

Mr. Smith, you are recognized for 5 minutes.

Mr. Smith. The chairman of the subcommittee has stated wisely that America's most potent armament in the world struggle between conflicting economic ideologies "is our ability to provide a continually expanding economic horizon and a continually improving standard of living for all."

It has been, and is, the expressed intention of this subcommittee to examine Federal tax policy as it may affect these basic objectives which we all recognize as vital to national well-being. Such an investigation is proper because in a democratic, capitalistic society where people are relatively free to make economic decisions, tax policy can, and does, have force upon such decisions and, therefore, does bring an impact, in greater or less degree, upon the entire economy. This is especially true and obvious when tax rates are high and when the scope of taxation is as broad as at present.

Each phase of our tax policy, therefore, is properly being weighed to determine whether it fosters or restrains economic growth and

stability. Wherever the subcommittee should find clear evidence that Federal tax policy retards or disturbs these objectives, it surely would be the subcommittee's duty to recommend appropriate congressional action. On the other hand, it is presumed that where tax policy has clearly contributed to the strength of our national economy, the subcommittee would not recommend modification without reasonable assurance that such change or changes would result in an equal or greater contribution.

One phase of tax policy—namely, that which relates to natural resources development—is the subject of our discussion here today. All of us will readily agree to the vital importance of natural resources to the Nation's economic strength. (Petroleum and natural gas furnish more than half of our energy supplies.) Evidence is abundant that tax provisions applying to oil and gas have accomplished well their nonfiscal purpose of stimulating the search for oil reserves. In 1925 the Nation's proved reserves were 7.5 billion barrels; today our reserves are near 30 billion barrels. It has been said that our country is the only major nation of the free world with sufficient oil inside its own borders for peace or war.

Beyond any reasonable doubt the demand for oil and its products will continue to grow vigorously in the years ahead. To meet that demand we must have more, not less, new discoveries. And in this connection it is significant to note that despite marked scientific improvements in the search for new reserves, the industry continues to discover oil only in about the same proportion to exploratory effort. The danger is great, therefore, that the Nation's economic growth and stability will be impaired, not furthered, by changing the tax policy now applicable to the oil and gas industry. The record speaks loudly and clearly against such change—certainly until such time as we can be assured that some other incentive will find the oil we need.

Some economists, ignoring practical aspects and assuming unreal premises, have argued that we should rely upon free-market price to furnish sufficient incentive to develop our natural resources. The President's Materials Policy Commission, after carefully considering this point went on record to the effect that "because of past erratic price behavior of minerals and the long interval between additional investment and yield from production" price incentives "are unlikely to bring about enough exploration and development to meet the national need for domestic production of scarce minerals."

The tax policy which allows percentage depletion for oil and gas has been reviewed many times by the Congress—so many times that there are scarcely any new arguments on either side of the question. Repeatedly Congress has found sound reason to retain the policy. And now in an age of advanced mechanized warfare in a world none too friendly, America's security is so much at stake that there is even greater reason to let the time-tested policy alone.

Mr. MILLS. The Chair, on behalf of the subcommittee, wishes to thank each of you for your appearance this afternoon, the information you have given this subcommittee in the compendium, and also in your statements, and we appreciate the contribution you have made to the thinking of the subcommittee.

I will ask Senator Douglas to begin the interrogation.

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Senator DOUGLAS. It seems to me that before we discuss the relative merits and demerits of the percentage depletion provision we should understand and have a common agreement upon what these provisions are. Therefore, I should like to start off by addressing a series of questions to any member of the panel to see if we can get agreement as to the facts.

Do I understand that in these extractive industries, and more particularly in oil and gas, the expenses of exploration and discovery are treated as current expenses and are therefore deducted from the gross income before taxable income is arrived at?

Mr. LAMBERT. Are you addressing your question to me?

Senator DOUGLAS. Mr. Lambert, you are a lawyer. Perhaps I will address them to Mr. Fernald.

Mr. FERNALD. I can answer that, Senator Douglas. For oil, the largest class, pure exploration is not a deduction from current income.

Mr. Lambert, I think, can explain that a little more in length.

Senator DOUGLAS. Did I understand you to say they were deductible or were not deductible?

Mr. LAMBERT. Most exploration costs, Senator Douglas, are capitalized and are kept in capital until an exploratory property is abandoned, which may take on the average 4 or 5 years from the time the property is first acquired.

Senator DOUGLAS. What I am trying to get at is once the well gets into operation and there is a flow of income, whether development and exploration costs can be deducted from gross income before we arrive at taxable income.

I understood Mr. Fernald to say the answer was "No."

Mr. FERNALD. For exploration costs, no. They are not classed as development.

Senator DOUGLAS. They are classed as development?

Mr. FERNALD. Development but not exploration.

Senator DOUGLAS. You say it will or will not? Is it or isn't it deductible?

Mr. FERNALD. Exploration is classed as one thing under the law, and specified there as exploration for new deposits, but intangible drilling and development on the particular well that is deductible.

Senator DOUGLAS. Then I understand the answer is that intangible or development costs are deductible?

Mr. FERNALD. Development; yes.

Senator DOUGLAS. All right.

Now, then, on the actual cost of drilling, which involves a capital expenditure, are those capital costs subject to deduction on the principle of amortization or depreciation?

Mr. FERNALD. I am going to suggest that——

Senator DOUGLAS. These are simple questions.

Mr. FERNALD. I will answer that. Since it is particularly oil, I thought one of your oil people might answer that a little better, but I have no objection.

Your intangible drilling and development expense, that is the cost of your drilling other than salvage materials which are minor, is currently deductible.

Senator DOUGLAS. I am speaking of tangible drilling; the cost of sinking the actual well. Is that deductible?

Mr. FERNALD. The cost of sinking the actual well, except for such material involved in that as to which there is expected to be salvage value; the cost of drilling the well is deductible unless the taxpayer has elected to capitalize it.

Senator DOUGLAS. Is there an agreement on facts?

Mr. STANLEY. Senator, in the interest of clarity, I might refer to page 481 of this book, where I touch on this very briefly as follows:

With respect, first, to exploratory costs, I believe Mr. Lambert has stated that that is largely capitalized in the first instance; only charged off then when properties may finally be abandoned.

With respect to development costs, down about the middle of the page I say, as follows:

For oil and gas wells, regulations classify drilling and development costs as tangible and intangible. As for mines, costs subject to the allowance for depreciation, "tangible" costs, are capitalized. "Intangible" costs are immediately deductible under regulations in effect since 1918, and under section 263 of the 1954 law. These are costs such as grading and making a location, labor, and other expenditures involved in boring the hole in the ground, testing and surveying, and costs of installing equipment. Such expenditures do not result in a tangible asset which could be sold or salvaged for any other purpose.

Then going down to the next-to-the-last paragraph in the middle of that page:

Taking into account not only the equipment placed immediately in and upon the well, but all facilities required for the development of a property, the intangible portion may amount to about 50 to 65 percent of the total development cost.

Senator DOUGLAS. What that says is that the intangible drilling and development costs, which we previously agreed were deductible, amount to from one-half to two-thirds of the total development cost?

Mr. STANLEY. That is right.

Senator DOUGLAS. The question I raised is the one of the capital investment in the well itself. There must be piping, naturally, to the edge of the well, and there must be pumping facilities on the surface in some cases, and so forth.

Is the cost of depreciation on these physical assets deducted?

Mr. STANLEY. Cost of all capitalized tangible equipment is deductible through depreciation.

Senator DOUGLAS. That is what I thought. At how many years?

Mr. STANLEY. It follows rather intricate rules that the Treasury set up. Some is depreciated on a straight-line basis and others are related——

Senator DOUGLAS. In the famous Bulletin F for depreciation, what was the length of time allowed?

Mr. STANLEY. Normally assets are classified, and some such assets are depreciated on a straight-line basis all the way from 10 to 20 years. Others are related to the units of production or the barrels expected to be produced.

Senator DOUGLAS. The expected length of the well or of the drilling?

Mr. STANLEY. That is right.

Senator DOUGLAS. Now, let me ask another question: Can the cost of drilling unsuccessful wells, or dry holes, if drilled by the owner or operator of successful wells, be charged against the income—gross income—derived from the successful holes?

Mr. LAMBERT. Dry holes are deductible from income of the producer in the year the well becomes dry.

Senator DOUGLAS. So that if that is 1 firm which does multiple drillings, and let us say drills 20 holes, 10 of which are dry and 10 of which yield, the cost of the 10 dry holes can be charged against the gross income from the 10 successful drillings?

Mr. LAMBERT. That is right; to the limit that there be gross income.

Senator DOUGLAS. And thus far we have not reached the question of percentage depletion.

Mr. LAMBERT. In certain instances, Senator Douglas, dry holes on a producing property will limit the depletion allowance of that property.

Senator DOUGLAS. I understand.

May I say up to this point I agree that these provisions are proper. The question is whether we should go beyond these provisions. That is the proper issue, and see if I understand the added provision.

The percentage depletion means that 27½ percent of gross revenue can be deducted for tax purposes up to one-half of net revenue, and that continues without regard to the relative life of the flow in the well, or without regard to the amount of the total invesment.

Mr. LAMBERT. That is correct.

Senator DOUGLAS. Is that correct? Do we all agree that this is correct.

Upon occasion people have accused me of not understanding percentage depletion, so I will now get a public record to see whether or not I do understand it.

Mr. FERNALD. Might I say, Senator, I have not wanted to dodge answering the oil things, but I thought those engaged in the oil industry were a little better qualified than I to discuss these relations.

Senator DOUGLAS. The record will show that you are certainly not trying to dodge the questions.

Now let us bring out some illustrations. Suppose the initial cost of the successful hole amounts to a mililon dollars. I believe the average cost is about $250,000, isn't it?

Mr. LAMBERT. Yes.

Senator DOUGLAS. Let us take a big well. Let us say it costs a million dollars, and it has charged against it—at least, the income of this well has charged against it—all these costs which I itemized, and possibly others that I haven't itemized, but at least it has these costs.

Now, suppose it continues to yield year after year, year after year, year after year, and the gross revenue, let us say, from the well is a million dollars a year.

Do I understand that you can charge off $275,000 a year, up to one-half of the net income, as long as the well continues to flow?

Mr. LAMBERT. That is correct. That is a high rate of return.

Senator DOUGLAS. I know. I am using this hypothetically. Incidentally, the figure I used would be gross investment. That is in excess of the average, which I understand is about $250,000.

So that if the well were to yield for 20 years' flow, you could charge off five and a half millions upon the original investment of one million. I say if it did yield for 20 years.

Mr. LAMBERT. In that theoretical illustration it could, but it is so theoretical, Senator Douglas, that it gives a misleading impression.

Senator DOUGLAS. What is the average length of flow of the average well? That is, for how many years does a well flow?

Mr. LAMBERT. It may last for 20 years, but it goes into rapid decline, and it goes marginal after a few years.

Senator DOUGLAS. Are there not east Texas wells which started to come in many, many years ago which are still going?

Mr. LAMBERT. Well, the average production of the Texas wells is about 13 barrels a day.

Senator DOUGLAS. I know. I was speaking, not of the average but some of the gushers. It has been a long time since I have been down at Beaumont and Port Arthur, but I was down there about 15 years ago, and, as I remember it, that was the first of the Texas fields to come in; isn't that true of the Beaumont and Port Arthur fields? Unless I was greatly mistaken—I admit my trip was a hurried one, for some of these original gushers were still yielding large quantities of oil after 20 years or more. Isn't that true?

Mr. SMITH. Some have long since passed out.

Senator DOUGLAS. I take it that is what we are talking about.

Now, let us see if we can go to the merits or demerits of the argument. There were two points Mr. Harberger made which interested me very much. One of them is a new thought. It is sometimes said that since the corporation tax amounts to 52 percent of net profits it doesn't make much difference who gets the income originally. Let the oil companies get it, and we will get back 52 percent through the corporation tax.

Of course, in dealing with the arguments of my colleagues who advanced this contention on the floor of the Senate, I said 52 percent is not a hundred percent; that if there is a higher price to the consumer or differential return, which the companies are not entitled to—to give back 52 is not to give back a hundred percent. I thought I saw dimly, although I admit I didn't cleary perceive Mr. Harberger's argument, that due to the pecularities of the capital gains tax in fact the amount of revenue return to the Treasury was less than 52 percent. Since I am very much of an amateur in this field in dealing with so many experts, I wonder if Mr. Harberger would make that point a little clearer, or did I misunderstand your point?

Mr. HARBERGER. My intention was the following: I took a hypothetical example to start with of what our tax system or incentive system would look like in the petroleum industry, even if we never had percentage depletion. Forget about percentage depletion. The fact is that because of the risks in the industry, the costs of any actual well which is successful has to be a very small fraction of the revenue that comes from the successful well, because the total revenue has to cover all of the costs of the unsuccessful wells in the exploring operation.

Mr. SMITH. Mr. Chairman, since this is informal, may I put a question right here? I think it is very pertinent, if he will yield.

Mr. MILLS. Would you yield for that purpose, Professor Harberger?

Mr. HARBERGER. Sure.

Mr. SMITH. I would like to call Professor Harberger's attention, and that of the committee, to a statement on 443 in Professor Harberger's expanded statement where he says, beginning with the last paragraph before his sectional break—so it is practically in the middle of p. 443.

He says:

> Whereas under discovery depletion it would be worthwhile for an explorer to spend $2 million to find $1 million worth of reserves, under percentage depletion it appears that to find $1 million worth of reserves an explorer would be willing to spend $1.95 million for oil, $2.11 million for sulfur, $2.13 million for iron, $1.96 million for copper, $2.27 million for lead and zinc, and $2.30 million for coal.

Then at the bottom of the same page, Professor Harberger says that his analysis has indicated that there is a substantial waste of capital being devoted to exploration, producing only about one-half as much value of product as the same capital would if devoted to ordinary industrial investment.

Now, that is a very severe charge against the natural-resources industry. I take it that Professor Harberger means by ordinary industrial investment one that has no depletion allowance associated with it, so I would like to ask Professor Harberger in that connection to clear it up for me and the subcommittee: Do you really believe that the oil industry is spending $1,950,000 to get only a million dollars worth of oil?

Senator DOUGLAS. Mr. Chairman, I wondered if Mr. Smith would be willing to withhold that question for a time, because as a matter of fact it deals with the next general question I want to ask Mr. Harberger, but at the moment I do not think it is immediately responsive to the point about which I was inquiring, namely, capital gains or the difference which is effected by the capital-gains tax, as compared with the ordinary corporate profits and tax.

Mr. SMITH. Senator, the reason I asked for permission to put it here is that, as I interpreted Professor Harberger's statement the two were inseparable, and I wanted the subcommittee to get his algebraic formula.

Senator DOUGLAS. I have no objection to the question being put in the record at this point, but before we pass to consideration of it I would like to ask Mr. Harberger the further question about the difference produced by capital-gains tax as compared with the ordinary corporate-profits tax.

Mr. SMITH. May we come back to this?

Senator DOUGLAS. Yes. My next questions, as a matter of fact, I think, will involve that.

Mr. HARBERGER. I think once it is recognized that the bulk of the resources devoted to exploration go into dry holes, and the successful holes only have maybe less than half of the total resources, and in any case the expenses attaching to successful wells can be deducted against ordinary income, one gets the picture here of the expense side of the income statement of the petroleum industry at large; the expense side is something which achieves tax offsets against other income at the rate of 52 percent, but whenever they do get a find, in the absence of the percentage depletion, they would be able to sell that find in the market and pay a tax on it of only 25 percent.

Well, this means that if their find equaled in market value their expenses they would be making 25 percent.

Senator DOUGLAS. That is as compared to the tax which they otherwise would pay.

Mr. HARBERGER. Just on the tax difference, that is right, and the Government is giving up full income taxes on all these expenses that go against ordinary income and only the capital-gains tax is added,

so that in effect the Government, because of the tax differential between the 52-percent rate on the expense side and the 25-percent rate on the income side, is giving a subsidy to this activity.

Senator DOUGLAS. That would only be true, would it not, Mr. Harberger, if the rights to the well were sold by the original driller to a later purchaser? Isn't that true?

Mr. HARBERGER. That is true, Senator, and this is what happened in the whole development of discovery depletion. The people who had wells in operation in 1913 could carry those wells on their books and deplete them at their 1913 market value, while the people who later found successful wells could carry them on their books and deplete them only at cost value, and they, therefore, had a strong incentive to sell out. In order to stop them from selling out, so to speak, in order to make this selling out unnecessary, the provision was adopted that, once you found a successful well, you could hold it and carry it on your books at is estimated market value. Well, as compared to the case I have already discussed, this would mean that the discoverer of the successful well gets it into operation, but no capital gains tax is paid at all. And yet it is carried on the books at the price at which it would be carried on the books of a purchasing company, but in the latter case under capital gains taxation the capital gains tax would have been paid. So the appropriate way of looking at discovery depletion is as circumventing the payment of even the capital gains tax. Then you get percentage depletion which was simply a rule of thumb operation to approximate discovery depletion.

Senator DOUGLAS. Is that what you meant, Mr. Gray, when you said that the percentage depletion has been capitalized by the holders of these properties into a higher value?

Mr. GRAY. Yes; that is what I said.

Senator DOUGLAS. And is this what you meant, Mr. Smith? Excuse me, it is Mr. Stanley's statement, the last page, page 5. Mr. Stanley says—

> In conclusion, percentage depletion at rates now provided in the law recognizes and approximates the capital value of producing properties, and is representative of the value created through discovery.

This sounds to me as if you are making an identical statement with Mr. Gray.

Mr. Gray said you capitalize the income stream resulting from depletion allowances in the properties, and Mr. Stanley says that you take capital value of producing properties and then the rate of return is based on that.

Now, those seem to me to be two different ways of saying the same thing. One starts from income and reaches capital value, the other starts from capital value and reaches income. The question is whether the capital value created by percentage depletion is a proper capital value?

Mr. Gray?

Mr. GRAY. Senator, this was one of the issues as you recall that was discussed by Dean Griswold in his exchange of correspondence with Mr. Baker, which is printed here with the panel papers. The question of whether advantages gained from tax immunity were the proper subject of capitalization. That was raised by Dean Griswold as well as myself, and Mr. Harberger raises it in a different form.

Senator DOUGLAS. Your contention is that it is not?

Mr. GRAY. That is my contention; yes.

Senator DOUGLAS. Mr. Smith?

Mr. SMITH. Senator, in that connection, and still not forgetting that I have a question I want to pursue——

Senator DOUGLAS. I won't forget.

Mr. SMITH. In that connection, the assumption is commonly made that the oil business is like retail merchandise business. For quite a number of years, as we all know, there has been almost an annual conflict over percentage depletion, and when you study the debate that has been going on you come to the conclusion that the real difference in the debate arises from the valuation of the depleted quantity. That is where the real difference finally focuses. Some opponents of the existing percentage depletion provision concede that depletion must be allowed, but they say it is unfair to permit as total depletion more than the costs which the owner of the wasting asset incurred in financing and developing the asset, and that is exactly the position that Dean Griswold takes.

Senator DOUGLAS. Including the cost of dry wells?

Mr. SMITH. Yes. After 100 percent of the costs are recovered there should then be no more depletion allowed on that property unless further outlay should be made and capitalized for depletion. That is the position that is taken.

Senator DOUGLAS. Not allowed through the tax structure?

Mr. SMITH. Yes. I think that position assumes, I repeat, that the oil business is like the manufacturing business, or like the retail merchandising business, but the position isn't strictly in accord with the economic concept of depletion because it assumes that return of capital is synonymous with return of capital cost, or capital outlay, and also implicit in the position is the assumption that capital cost, when recovered and reapplied, will find and develop a similar amount of the wasting asset to replace the quantity severed; just as it is assumed that depreciation on the part of a manufacturer will set him up enough in reserve to replace exactly the machinery that has been worn out, but the difference is that your manufacturer can, with fairly reasonable assurance, barring price changes and that sort of thing, go out and replace wornout machinery with the amount he has set up.

That isn't strictly true in natural resource industries because you don't know what it is going to cost you to get back your 100,000 barrels of oil or million barrels of oil, or whatever amount of oil there is. You don't know what it is going to cost you to get it back. In the first place, you don't know whether you are going to find any or not, so there is a different sort of situation which I thought ought to be tossed in in reply to the point made here. It is just a different sort of economic situation.

Senator DOUGLAS. Now we are approaching the point that you have previously raised, and have touched on now. I will start that off with sort of a general query and then make it more precise. The query comes as to whether the value of the reserve should be fixed by the tax structure, or whether it should be fixed by the forces in the market, and that leads me to the question I wanted to ask Mr. Harberger and to which I think you responded earlier, namely this:

We have had a number of witnesses at previous sessions who have testified that if we are seeking balanced economic growth with a mini-

mum sacrifice of current living standards, we should try to see to it that the Federal tax system does not interfere, repeat, does not interfere with the most efficient use of our resources.

As I understand the general import of Professor Harberger's paper, he makes the case that in a free market economy, the most efficient use of resources would result when they are allocated among alternative uses in such a way that the marginal returns in each case, or in all uses, are equal.

He also states that this result will not follow if the tax system taxes some type of returns less heavily than others.

Am I understanding you correctly?

Mr. HARBERGER. That is correct.

Senator DOUGLAS. By these tests he concludes that the most efficient use of resources is not being promoted by the present tax provisions with respect to income derived from natural resources.

I wondered, Professor Harberger, if you would elaborate at this point and then would the other members of the panel address themselves to the same question, leaving out other issues for the time being. Mr. Smith, we are coming to your point now.

Mr. SMITH. Thank you, sir.

Senator DOUGLAS. Mr. Harberger, would you lead off?

Mr. HARBERGER. Well, I think one can see this thing very easily if you look at a setup where you tax the return to some kinds of capital, at, let's say, 50 percent, and to other kind of capital, let's say, 5 percent; if you just arbitrarily make some classifications of that kind.

Obviously, the incentive here will be to push returns——

Senator DOUGLAS. Would you speak more loudly, Mr. Harberger?

Mr. HARBERGER. The returns to capital after taxes are going to be the same in all industries so long as we have a competitive capital market. If a result like this, where $2 billion is spent for $1 billion worth of oil, should happen to come out, this is certainly not something for which the people who put up the capital are to blame. They are getting their 8 or 10 percent, whatever it is, after taxes, which is what everybody else is getting, but in the process of getting 8 or 10 percent return after taxes, they use a lot more resources before taxes; if you take a case where you have a tax of 50 percent in one industry, 5 percent in the other industry, and if the return to capital after taxes is 10 percent, then the industry with the big tax will only be making investments that pay off at 20 percent, while the industry with the little tax will be making investments that pay off at only slightly more than 10 percent. This is inefficiency from a social standpoint.

We would do better by having a little less capital paying off at 10 percent and more paying off at 20 percent. The only way you get this straight is to equalize the rates at which you tax capital in all its uses.

Now, in the petroleum industry with this depletion business we carry to a great extreme this sort of thing. The result is that if you just take $3 billion and put it into oil exploration, if you get back $3 billion before taxes out of that, then because of depletion, fantastic profits are being made. Now I don't believe, and in fact we have a lot of testimony here that bears me out, I don't believe the oil industry is making fantastic profits on the capital it puts in. What happens is that everybody runs into the business of exploring for oil, until the return to that business is pushed down, after taxes, to where it is in the rest of the economy.

Senator DOUGLAS. Mr. Smith, I think that was the approximate point that you had.

Mr. SMITH. Yes. Thank you, Senator.

Senator Douglas will recognize this analysis as what they call in economics the technique of marginal analysis.

Senator DOUGLAS. That is right.

Mr. SMITH. I want to ask pointblank Professor Harberger whether or not he has made this statement that it takes $1,950,000 worth of capital to get $1 million worth of oil. Did you make that statement?

Mr. HARBERGER. I believe so.

Mr. SMITH. Let me ask you this question: Have you gone to the industry to ask them what they spent over a period of time for exploration and development, and asked them what they found for that expenditure?

Mr. HARBERGER. No, sir.

Mr. SMITH. Wouldn't it have been better for you to do that than to use the technique, which is highly theoretical and academic, of a formula such as you have done in the appendix attached to your paper—wouldn't it have been much better for you to have done that? If you had, you would have found over the last 4 years that the industry has spent about $14,400 million for exploration and development—and found about 15.9 billions of barrels of oil, easily worth $1 a barrel, in the ground? That doesn't sound like any 1.95 for 1.

Mr. HARBERGER. The problem here is, I want to conceive of this thing as a total balance sheet of petroleum exploration in the economy. In fact—the big problem is you can't get a decent valuation of oil in the ground. It is very, very hard, and it is a fuzzy thing, because our percentage-depletion laws really work to prevent the alienation of properties. Everybody wants to keep their properties, and those people who do sell for capital gains sell for rather special reasons, and this is the only way we can get even any notion of the value for it.

I would rather say that if $14 billion has been spent, and $14 billion worth of oil in the ground—appropriately construed—has been found, then we just have to recognize that that $14 billion that has been found has a tax rate applying to it much less than the 50-percent tax rate that was used to offset the expenditures. This means somebody made a fantastic amount of money. I don't believe it.

Senator DOUGLAS. May I see if I understand you, Dr. Harberger? You are not pretending that these statements which you gave on page 443 were necessarily an actual factual analysis?

Mr. HARBERGER. No.

Senator DOUGLAS. What you were trying to do was to develop a line of reasoning and you chose merely an illustration?

Mr. HARBERGER. That is correct. Our tax laws give these incentives, and if people are acting rationally and trying to make money in the business world, which is what I think they are doing, and if our business world is competitive, then the results that I state are correct.

Senator DOUGLAS. I don't want to interfere with the contestants or combatants in this matter, but I want to see if I further understand you.

Do I understand you to say that after taxes, probably the marginal return in the oil and gas industry will be the same as in other industries?

Mr. HARBERGER. That is correct.

Senator DOUGLAS. But since the oil and gas industry receive the depletion allowance that the returns prior to taxes would tend to be less than in other industries?

Mr. HARBERGER. That is correct.

Senator DOUGLAS. And, therefore, you would have energy devoted to purposes which from the standpoint of society as a whole yield less than the margin for the economy as a whole?

Mr. HARBERGER. You are absolutely correct.

Senator DOUGLAS. Mr. Smith?

Mr. SMITH. Senator, you have been very kind to him. You tried to bail him out, and if I were in his position I would appreciate very much your help in that regard. I go back now to the statement that he makes at the bottom of page 443. That is the only thing really that I object to. He is using in the middle of the page a theoretical technique involving a formula which he develops in the appendix of his paper, and says, "The investor or explorer would be willing," up in the middle, and then down at the bottom he says, "his analysis has indicated that there is a waste of resources because there would be spent $2 to get approximately $1 back."

Now, the good professor has jumped from a classroom theoretical blackboard sort of thing using the marginal technique, overlooking average costs, and average findings, etc., and he has accused the natural-resources industry of wasting capital. I don't think this subcommittee should let that pass, or accept it, certainly, without very careful analysis of his algebraic equation, and I asked him whether he had gone to the industry to see whether that was true or not, and he said that he hadn't, but that he had done it in the classroom.

Senator DOUGLAS. I have always thought there was a place for deductive logic in the world, and——

Mr. SMITH. There is.

Senator DOUGLAS. I also realize there is a place for induction and statistics. I was very much interested in the paper of Mr. Lambert on page 456 in which he indicated that over a 9-year period from 1946 to 1952, the net income after taxes in petroleum was 15.2 percent of net worth and in other industries, 14.2. In other words there was an approximate equality between the two. Therefore, this would seem to corroborate what I understand to be Mr. Harberger's point, namely, that after taxes the return in the oil industry will approximate those in other industries, but because of the special tax provisions granted to the oil industry, the return prior to taxes will be less. It will be below the margin and therefore, socially speaking, there is energy, labor, and capital devoted to this industry, which yields less than the margin and hence does not maximize output. So I want to thank you, Mr. Smith, for emphasizing——

Mr. SMITH. I am not through, if you will permit me——

Senator DOUGLAS. This need for inductive material which seems to me to corroborate the deductive reasoning of Mr. Harberger, which confirms my feeling that it generally conforms with facts.

Mr. SMITH. I had Senator Douglas' permission before you did, Mr. Harberger. Let me ask Professor Harberger one more question. If he thinks what he says is due to the depletion allowance, then I would like to ask him why he comes out with a wasting of 1.95 to 1 in the

case of oil, which has the highest depletion allowance—but he comes out 2.30 to 1 for coal that has 5 percent depletion. If he will tell me how he got that, I would like to know.

Mr. HARBERGER. I can do that very simply. The problem is that the benefit that comes from the depletion allowance depends on how large the rate of depletion, percentage rate of depletion, is compared with the life of the asset. Now, if you have an asset that lasts for a long time—take coal mines, they seem to last forever—they get a very low rate of depletion, but that low rate of depletion being taken over a longer time accumulates up.

The oil industry has a high rate of depletion, but the typical oil well, the average life of the well if you want to get some concept of that, is more in the order of 15 than 50 years, certainly, and the higher rate of depletion combined with the shorter life turns out to yield something like the same figure.

Mr. SMITH. Mr. Chairman, I would like to ask if this logic is all right: A statement is made that because of depletion allowance there is a waste of capital and here is an industry, namely, the oil industry, that by the professor's technique uses $1.95 millions to find $1 million worth, and that industry has 27½ percent depletion. Then he says that in the coal industry that there is far more waste, $2.3 millions to get $1 million worth of coal, and yet the coal industry has only 5 percent depletion. I cannot see what he means. He is saying there is more waste of capital in the coal industry than there is in oil.

Mr. HARBERGER. First of all, I am not saying there is more waste of capital in the coal industry because there isn't. The things that I figured out here were the amounts of expenses that it would be worth while for an explorer for oil on the one hand, and an explorer for coal, on the other hand, to put out in order to obtain a typical cross section of properties in the industry, which would be worth, once it was there, and under ordinary taxation, would be worth $1 million, let's say.

Mr. SMITH. That is if it is driven to the margin?

Mr. HARBERGER. What I am coming to is that in the coal industry, while there is this potential incentive for exploration, nobody explores because we have got all we need. And in the oil industry where exploration is a daily and continuing thing, any whole year's production or new discovery, was completely marginal last year, next year's whole discoveries were completely marginal this year. Every year we are pushing out on the margin; the entire exploring operation is entirely marginal. Especially as in the case of oil among our minerals; that is the place where this marginal analysis applies also the average of the activity, you see.

Senator DOUGLAS. Mr. Lambert, you have been wanting to break in for some time.

Mr. LAMBERT. I would like to bring this particular discussion to what I call focus in my mind. Professor Harberger has very skillfully attempted to demonstrate that this misallocation of resources has resulted because in the free economy the tax provisions have tended to equalize what is a low rate of return industry before taxes, with all other industries, so that they are even in terms of rate of return after tax, and I think the graph that you refer to in my paper tends to bear this out, but where I part company with Professor Harberger

is when he said that this is bad, and he deplores it as a waste of natural resources.

I say this is good. I say that from a national-interest standpoint this is a necessary thing. To me, a very significant factor in the development of the standard of living of all peoples is their per capita consumption of energy, and the difference between our standard of living and that of the rest of the world is largely the difference between our rate of energy consumption per capita and that of other countries.

In the United States, our rate of energy consumption through petroleum is 20 times that of the rest of the world.

I can't deplore this. I can only be glad that this has happened, and I think to a large degree this is due to the functioning of the depletion allowances, in bringing about this equality, in eliminating what I term a disincentive, which would exist if we did not have these provisions.

So I cannot agree with Professor Harberger that this is a shocking waste. I would say this is a necessary and valuable thing to our economy.

Senator DOUGLAS. I think Mr. Harberger should have a chance to fire a volley in reply.

Mr. HARBERGER. My position on the subject is this: I believe firmly that our economy couldn't be at its present level or achieve the kind of growth that I hope without great consumption of energy resources. The question is where can we get these necessary energy resources the most cheaply. Here we have a situation over in Arabia with 3 times apparently—I have heard at least it is something like 3 times the reserves of some of the biggest United States discoveries, and the Middle East oil is extremely cheap. Why should we pay $2 for a barrel of our own oil when we can pay $1 for a barrel of oil bought in Kuwait. We use the resources in an equivalent way.

If we get the oil in Kuwait we take our resources and put them into manufacturing automobiles, ship them over there, and we get oil a lot cheaper. This is a good thing, but we do have national-defense problems, which I do think may be real, but I think deserve consideration on their merits and on their merits alone. Let may say also, however, in respect to this differential treatment, I suspect that most of my antagonists in this particular controversy are people who in principle would like to see the corporation income tax at zero.

If this is true, then we are all in agreement, because I want that kind of relative treatment of industries, which would appear if the corporation income tax was at zero. I want equal treatment of the expense side and the revenue side of the ledger, and naturally when it is zero it has to be equal and if it is 50 percent it ought to be 50 percent on both sides and the same goes for any other percentage that you may want to name.

Senator DOUGLAS. I think we ought to let each other discuss this in turn, Mr. Stanley.

Mr. STANLEY. Senator Douglas, what has been called marginal analysis here is in my oil-field language, we could call it a break-even point. In trying to theorize up from a break-even point, it just doesn't come out the way this industry operates. I am most amazed that on page 443 of Professor Harberger's papers that in effect he says that the development and the production of oil and copper, and iron,

and lead and zinc and sulfur, and I suppose we could make a long list of those things, are just not worth the time and money we have spent on developing them and producing them, and he remarks that the same capital could be better devoted to ordinary industrial development. I don't know what we would use for raw materials. I don't know what kind of development we would have. Probably we would make comic books, or expend the money in other types of enterprise—Disneyland from the part of the world where I come from might be a better utilization of capital.

We are offered as an alternative to this the operation of the price structure, to pay more for oil, to have less oil, and to depend more on foreign oil. I just can't agree that that is in accord with our national policy or the desire of the public.

Senator DOUGLAS. I don't want to get into the maelstrom of the contestants, but I will step out of my judicial role a little bit.

Mr. Harberger was not saying that we should abandon all investment in oil and gas and copper, sulfur and zinc and coal. Quite the contrary. He recognizes the necessity for these minerals and fuels, but what I thought he was saying was that we probably were investing too much, and it is just a question of more or less. Since he has introduced the rich oil hills of Arabia into the picture, it would seem to me that if we could get some oil into this country at production costs, plus a liberal payment to the governments of those countries, plus actual transportation costs, it would be a very real benefit. But I don't want to get into the pricing structure of Arabian oil, because as I understand it, what happens is that the price of oil in Western Europe consists of the price of oil in Galveston, plus the price of ship ment from Galveston to Western Europe, even though the oil as a matter of fact came from Arabia. In other words, we had a world basing point system, with Galveston, I believe, as the basing point, regardless of where the oil comes from.

Mr. Gray, do you want to add something?

Mr. GRAY. I was going to make a comment upon your general question about the equality of the tax system. I take it that much of the discussion we have just had here about the misallocation of resources goes back to your general question of whether then we think the tax system ought to be relatively neutral. My position is that we would fare better with as much neutrality as we could get in the tax system, and since I was one of the panel members who suggested greater reliance on the price system, I want to return to that as a possible alternative lest it be forgotten.

Senator DOUGLAS. That interests me. Here we have the members of the academic profession standing for a free-enterprise system, with the tax system neutral, and our practical friends here from the industry saying that the tax system should be so devised as to encourage the production of additional quantities of oil.

It seems to me that our friends here are really State interventionists as compared to the noninterventionists as represented by the academic profession.

Mr. SMITH. Senator, you are not going to give me the time that is needed to comment on that, but I don't think you actually believe that.

Senator DOUGLAS. That is the only conclusion I can draw.

Mr. SMITH. Here is something that has been in existence for 30 years, and the Congress on no less than a score of occasions has gone into it

just as you people are. Each time I presume they have said that to remove it would do more damage than to leave it alone—at least, they have left it alone, and I can't find any particular cleavage between Democrats and Republicans on it. There may be a slight geographical division on it, but I think the Senator was kidding us, so I will stop.

Senator DOUGLAS. Mr. Chairman, I think that I have taken up more than my share of time with my questioning. I want to thank the participants. I think it has been a very healthy discussion, and it has perhaps, I hope, introduced enlightened argument and logic into what was possibly an emotionally charged subject.

Mr. MILLS. Mr. Curtis will inquire.

Mr. CURTIS. First, I would like to comment, Mr. Chairman, that this panel discussion has taken exactly the shape I hoped it would. Having read all the papers involved, I was sort of hoping that there would be sufficient panelists present to reply to each other. They have brought out very strong and different views.

The other point I want to bring out is how wholesome this procedure is. Usually this gets down to epithets and questioning people's motives. This discussion has been on the plane it should be on. It is a serious economic problem. I don't profess to know the answers, but I do recognize that there are very sincere men on both sides of the question, and it isn't a question of being for the rich or poor or anything of the sort.

Now, it gets back to one of the basic questions involved here, terminology of whether we are talking about a tax treatment that is a preferential treatment, or what I term a differential treatment.

It seems to me one thing would be true, and I will ask the question if that is not so. The reason I say it is not preferential is because this is open—this field of the oil industry, of course, is open to any investor. Incidentally, Senator Douglas, this morning I think you took me at a little bit of a disadvantage when I was discussing that. I was referring——

Senator DOUGLAS. I never do that.

Mr. CURTIS. I know you wouldn't intentionally, sir, but I think you unintentionally did because I was discussing in the use of the two words the investor class, once it is already there; whether or not a tax that gave a differential to one form of investment over another would be preferential, because it was available to all investors. I think that is very true in this or any of these others. Any investor can be in this field; any American. In fact, foreign capital can go in, so it seems to me it is purely a differential. If this were so, if there were too great a differential, I would think the oil industry would be overcapitalized.

Is there any indication it is overcapitalized? I ask that from any of the members. Mr. Harberger, do you know whether there are any statistics that would indicate that the oil industry is overcapitalized?

Mr. HARBERGER. I am not quite clear as to the meaning of overcapitalized, because the technique of production of oil is a reasonably fixed one, and what happens is if you have a special—what you call a differential treatment——

Mr. CURTIS. Perhaps I can word it differently. I meant more capital than is needed for its development. That is what I meant by overcapitalized, more capital available.

Mr. HARBERGER. The burden of my argument is exactly this, I believe: That the oil industry is overextended in our economy; that we do too much exploring for oil; that capital, because of this tax treatment, just pours into the thing at the rate of $3 billion a year, and in the process the capital is there predominantly for reasons of a tax advantage.

The people who actually do the investing are not getting any more rate of return than anybody else because it is a competitive market.

Mr. CURTIS. That intrigues me. The test really of whether there is more capital going in than there is need for is how much oil reserves there are. Mr. Lambert?

Mr. LAMBERT. I would like to address myself to that question. The oil industry is not overcapitalized in the sense that there are more resources in there than they need to meet demand. As I brought out in my summary, we are going to need far more oil in the next 15 years than we presently see our capacity to produce. We are going to need great amounts of capital. The oil industry, as has been brought out in my paper, and maybe others, appropriates more of its gross income to reinvestment in exploration and development than any other industry, and yet there still isn't enough to keep up with the demand. We have a margin of reserves times annual production that wavers between 11 and 13 times annual production, which is scarcely enough, and in the next quarter century, we are going to be very, very hard pressed to find enough capital to explore and develop the oil we are going to need.

The oil industry isn't overcapitalized in the sense that we have got more money than we need.

Mr. CURTIS. That is the economic question that I think is very important to determine whether we do have the adequate oil reserves that we should have in this country, based upon our needs of our society—not only our needs for a peacetime society, but for defense. I gather there is disagreement on the amount of reserves that we have, in the panel; as to whether we have adequate reserves, or inadequate. Perhaps that would be the test of this business of whether there is more capital than needs be in this industry. I mainly want to know if there is any disagreement. Let's put it in the positive way. The statement has been made that our reserves not only may be adequate right now, but in the very near future, the statement is made that they will become inadequate, and therefore more capital rather than less is needed. Does anyone disagree with that? Let's see first if anyone disagrees with that observation.

Mr. HARBERGER. I will have to disagree with that in order to be honest here.

Mr. SMITH. To be consistent, sir.

Mr. HARBERGER. I think that—also consistent—honesty and consistency go together—I think that part of this business about oil reserves is connected with the fact that the industry usually only proves up those wells that are in reasonable prospect of coming in within the next 10 years. There are many categories of reserves and the proved reserves have always been between about 11 and 12 years' supply, while people have known about things called inferred reserves

and other categories, which are oil that we guess is there, but we are not so sure because it hasn't yet been worth while to find out.

Now another thing, however. Suppose, to take a very extreme example, suppose the Government were to say to anybody, "Any dollar you put up for oil exploration, we will add 10." So that you have a fantastic incentive. You have got a great deal of capital pouring into this business, and what would happen? I would predict what would happen to be a great expansion of the oil industry. If we were the only market that would drive down the price of oil; a lot more oil would be used than was previously demanded and the people who were putting up their dollars, because of its competitive activity wouldn't be getting any more return than anybody else. All we would be doing would be pouring resources into this business until we were working our oil very, very inefficiently.

The other problem was whether we don't have enough reserves. In some real sense our reserves are the amount of oil that is under the ground in this country, speaking of this country alone, and in the sense that Mr. Nelson was bringing out, the faster we try to use them up, the worse shape we are going to be in in the future.

Mr. CURTIS. Unless we have another form of energy.

Mr. HARBERGER. Unless we have another form of energy.

Mr. CURTIS. I was intrigued with your statement that we would use more than demand. I don't quite understand what you meant, that we would be using more than demand for oil. How would we?

Mr. HARBERGER. No. The amount of oil that people would use would increase as the price went down. It would get very cheap.

Mr. CURTIS. The point is your standard of living would go up, which I hope we are all looking for.

Mr. HARBERGER. This isn't true, because of the $10 that the Government is putting up as a subsidy here, in my case, a strict subsidy. They are using machines, automobiles, trucks, and all the other pieces of capital equipment that could be used in other uses, where it would pay off at 20 percent, and here is a use wherein capital isn't paying off even 2 percent.

Mr. CURTIS. That is sort of begging the question, of course. The whole issue, as I see it, at any rate, the question is to know what we do need in our economy in the way of oil reserves. Of course, I don't quite know how we can get the use ahead of demand. I suppose it could be done. Did you have a comment, Mr. Nelson?

Mr. NELSON. On the question of reserves, I have before me here the most recent Petroleum Facts and Figures. This is the figure for 1953. It shows changes in proved reserves due to extensions and revisions during 1953 of 2,704 million barrels, and proved reserves discovered of only 591 million, less than one-fourth as great.

In other words, you have a situation here where necessarily your reporting or proved reserves is rather nominal and you don't exactly know. You want to be conservative if you can. I have often wondered how much of the rather surprising 10 to 12 years' reserve that we have on hand year after year after year is a real economic reserve in any recognizable sense or just declared reserve. On another project I was on once, in mining, it turned out that one of the biggest mines had only 2 years in reserves. I was naive and thought that a horrible

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reserve situation. They pointed out local taxation was on that basis and they didn't know because they didn't block out any more than that. They said they were reasonably certain that they had more reserves.

Mr. CURTIS. In my judgment, it becomes very important that we get to this basic statistic and if it isn't a real statistic, we ought to know what it should include, and make a comprehensive analysis of it.

Mr. SMITH. I think it is pretty generally agreed that there ought to be some margin of safety in case of a national emergency. It is not exactly proper to compare oil with other reserves because the speed at which you take oil out of the ground has something to do with how much reserve there is there.

Mr. CURTIS. I don't think we are comparing. We are trying to find out what it is. If we know what it is, we can compare it.

Mr. SMITH. It is approximately 30 billion barrels at the present time, and that is somewhere around 11 or 12 times our annual use of oil. It was estimated in 1952 by the President's Materials Policy Commission that by 1975, we would be using 13.7 million barrels a day, which is almost twice as much as we are using now. Now, if the margin of safety ought to be about 11 to 1, or 12 to 1, we would have to double, more than double, our reserves between now and 1975, in order to have that margin of safety.

Mr. CURTIS. What would you comment on Mr. Nelson's observation, though, as to the different kinds of reserves? This reserve you are talking about is in the category of proved reserves. Is there actually this different kind of reserve, where you know or feel pretty certain that there are fields that could be developed?

Mr. SMITH. I know he is questioning the accuracy of those statistics, and the figures are so large that certainly I would be willing to say there is plus or minus margin.

Mr. CURTIS. I don't think it is questioning accuracy. As I understand he is questioning what it refers to. It apparently refers to proved reserves.

Mr. SMITH. It refers to recoverable reserves.

Mr. CURTIS. From the standpoint of the industry there is another type. Mr. Lambert?

Mr. LAMBERT. I think the term refers to known reserves and, of course, there are unproven reserves beyond that, but no company, I am sure, no producer is deterred from proving up reserves by fear of local taxation. In fact, as you know, almost all oil production is on land owned by small landholders, and they have an interest in having it proven up and developed, so no producer, no explorer, is proving up reserves and then keeping them to himself, you might say. They are proving them up and they are going into the equation of the national proved reserves.

Mr. CURTIS. Did you have a comment?

Mr. NELSON. The only comment I was trying to make was simply that the annual figures are not really figures for new oil—"proved discoveries" as sometimes labeled. Most of the increment in our reserves each year is a result of extensions to existing fields and that kind of thing. I felt the discussion was getting off in the direction of what is brought in by wildcatting each year which is a different proposition.

On this question of waste of resources, it would seem to me that a major issue might very well not be the exploration issue, but the issue of drilling resources in known pools. To be inductive, which is unusual for a professor, I had a couple of students who worked in the oilfields of a leading producing State, but not Texas, and they came back at the end of the summer and they said they had quite a job, losing money. They said they were working on wells that would come in and produce 5 barrels of oil a day, and we figured out that the capital cost was greater than the proceeds the well would yield. I said how did they do that. They said it was easy. They said this 5 barrels a day will yield revenues which will increase the operator's gross, which will increase his percentage depletion, which means that even though there is a loss on the additional wells, the extra percentage depletion will allow additional income from his total of wells. It can be figured out arithmetically.

Mr. SMITH. Oh, no.

Mr. NELSON. We figured out an example. I can show it to you. Do you want me to work out the arithmetic on it?

Mr. CURTIS. I would be glad to have the panel discuss that. I hate to monopolize the time here, but I am very much interested in this.

Mr. SMITH. I think somebody ought to take him on that. His students probably misunderstood the tax regulations. The truth of the matter is that on a whole lot of those strippers the 50-percent net applies and keeps depletion allowance from having any effect at all.

Mr. FERNALD. I have been keeping out of this oil matter pretty much because I felt that those who knew more about oil than I should be discussing it.

There is a narrow margin within which what has been stated may be true. That is the margin between your 27½ percent of gross and your 50 percent of net. You see, we have a double limitation. If 27½ percent of net, or gross, is less than 50 percent of net, you are limited by 27½ gross. If, however, your 50 percent of net is less than 27½ gross, you only get that, the 50 percent of the net. Now, there is a narrow margin conceivably—and I will assume perhaps that existed in this particular case, where, if we say, for instance, your 27½ percent of net was 275,000, your 50 percent of gross was 300,000, if you could bring in some little wells which would boost up your 275,000, you might get to the point where your depletion on gross raised to, we will say, 290,000 would then just equal 50 percent of your net. Now, there is a narrow differential in there where what Professor Nelson has said might be true. It is just one of those minor points of variation which you can get in this very complicated situation.

Mr. CURTIS. It would require another technical revision perhaps.

Mr. FERNALD. You have to have somebody who goes into this very technically to find out whether you are coming within that line or whether you are just fooling yourselves. It is an exceedingly technical point.

Mr. NELSON. This is a minor point, but that is what they were doing.

Mr. CURTIS. We are interested in that, too. I wanted to conclude with one general point that I wanted to bring out, and that is in reference to the table that Mr. Lambert put in on page 456, which has already been discussed.

To me, that is the other basic factor that we have to know, in order to estimate what these depletion laws have been doing to this particular

phase of our economy. Far from drawing the conclusions that have been drawn from these figures, it would indicate to me that if these are basic figures, and include all the petroleum industry—whether it includes purchasing producers—that is a pretty good indication certainly that there have been no bonanzas to the investor in the oil industry.

Mr. LAMBERT. To which I would like to add, Congressman Curtis, that the investor as a shareholder in the oil industry is likely to receive less in dividends in proportion to the earnings of his company than almost any other industry because of the necessity to plow back capital for further exploration.

Mr. CURTIS. Is there a differential between owner, producer, and developer, where one particular segment of the oil industry might be getting a low return, while another might be getting proportionately higher return, or, as you say, is this fair?

Mr. LAMBERT. The rates of return vary.

Mr. CURTIS. I know, between individuals, but between broad groups, like owners, producers, and developers.

Mr. LAMBERT. The rates of return are slightly higher in the producing than in the refining and transportation ends. These figures are based on integrated oil companies, which cover all phases of the activity. They also include a lot of producing companies.

Mr. CURTIS. This kind of comparison with the rest of our industry wouldn't indicate to me that even with our depletion laws, that there is this tremendous incentive for the investing public to move into this area.

Mr. HARBERGER. I would like to comment on that, sir. Suppose it were true that capital in oil would pay off 25 percent. General Motors, CBS, and everybody else would be down there drilling for oil. This is at least my position, and they will do that, until they make the rate of return equal to what they get elsewhere and they will push out and drill too much, what might be too much from the standpoint of economy.

Mr. CURTIS. You are getting back to the question of oil reserves.

Mr. HARBERGER. The explorer can make this thing equal, but this is something the competitive system will practically guarantee.

Mr. CURTIS. We have a healthy situation as far as investment is concerned unless your basic thesis is borne out by the facts. It would mean the reserves are really existing, or way beyond the need for them.

Mr. LAMBERT. Which they are not.

Mr. CURTIS. I am not begging the question. I am saying it turns on the determination of that fact, it would seem to me.

Mr. HARBERGER. May I suggest the reserve picture is something that really ought to be determined by the market profitability of the operation?

Mr. CURTIS. Not when we have the national defense.

Mr. HARBERGER. That is a special consideration, and I believe it deserves a great deal of thought, as I said in my paper. I don't think we can just pass that off, but from the standpoint of our economy, more or less as a running economy, there is this oil reserve, and when it becomes profitable to find it people will go out and find it, and if our needs for oil keep growing they will go and they will look and

the cost of looking will be reflected in the price of oil, which I think is as it should be.

I don't think the question is whether the reserves will really change. The oil in the ground is there. It ultimately will be discovered some day. Should we spend our resources now to discover and use that oil, or should we defer that use of our resources to some future date and rely partly on the Kuwait to provide us?

Mr. CURTIS. It will still come down to our actual economic situation, of our per annum use, plus what reserves we have. I appreciate your bringing this out. At least to my mind the question becomes clearer.

Mr. SMITH. Congressman Curtis, that is just exactly where I came in before. He is right back to making the point that there is a waste of capital resources.

Mr. CURTIS. The question is, it can easily be determined. What is your actual situation on reserves? If they are excessive there is something to his point, in my judgment. If they are not, I don't believe there is anything in his point then.

Mr. NELSON. Could I raise a question on that, please? This is something I have never seen discussed. I think it is worth discussing, and I quote from General Thompson who is an authority on this if anyone is. He says in various places that production per well per day in the Middle East runs from 5,000 to 10,000 barrels, depending on which quotation it is. That may be compared with United States production of the order, on the average, of only 13 barrels. That includes a lot of old wells in Pennsylvania, but even the Texas average is not much higher than that—on the order of 20 barrels per day.

Granted the Middle East is a long way across the world, tanker transportation is cheaper than land. I think there is a serious issue whether we are better off exploiting 20 barrels a day with the highest paid labor in the world.

Mr. CURTIS. That is limited conservationwise. We are deliberately doing exactly what Professor Harberger said, in many of our States we are limiting production; isn't that true?

Mr. NELSON. It is. The question that arises there is how much. It is hard to find out how much is for conservation and how much for other reasons.

Mr. CURTIS. That may be true. Let us put it this way: Whatever the reasons——

Mr. NELSON. It makes quite a bit of difference where you go from there what the reason is.

Mr. CURTIS. I am talking from the standpoint of your thesis. The point remains from an economic standpoint there is a straight regulation limiting those consumptions. I don't know what those wells would bring in if they were unregulated like those in Arabia are.

Could anyone here tell me? Are the wells in Arabia flowing 300 barrels?

Mr. NELSON. May I give you an idea of the statistical problem? I have two quotes, both from General Thompson who controls the Texas industry and presumably is in a position to know. One is that the average production would be 25 versus 20 barrels per day, and another is that a particular well would yield 30,000 barrels per day free flow versus 12½ with restriction. There is a difference that is hard to reconcile. They are both in the same context.

I would say, however, that the restriction has now reached the point where I would raise a serious question: Wouldn't it be wise to have unrestricted production in this country, simply bring over all you can get—it comes from a very critical area—dump it down wells in this country and if need be bring it up?

Mr. CURTIS. You have a physical problem there.

Mr. NELSON. Secondary recovery is exactly that. I see these statements that it costs so much, if you get so much more secondary recovery. How much would this cost?

Mr. CURTIS. Can you stockpile? Maybe you can.

Mr. NELSON. You can stockpile anything if you want to pay the cost. The question is: How much does it cost? I would like to find out.

Mr. CURTIS. Maybe Mr. Lambert can tell us.

Mr. LAMBERT. I never heard of that proposal before, but I would say that would be misallocation of resources.

Mr. MILLS. Senator Goldwater will inquire.

Senator GOLDWATER. In these hearings we are attempting to explore ways that we can arrive at some recommendations to the Ways and Means Committee, and the Congress, for a taxing program that will contribute to all of the economy, large and small.

Now, I think this afternoon we have made the same mistake that we always tend to make when we get talking about business in this country. We think of oil as Standard Oil and Union Oil, and all the giant companies. I am not from an oil State. I wish that we had oil in Arizona, but we don't have. But I have a feeling that there are a lot of operators in Texas and California, Oklahoma, Arkansas, and the other places that produce oil, that you couldn't classify as big producers.

Mr. Stanley, am I correct in that assumption?

Mr. STANLEY. Yes, Senator Goldwater. I don't have any recent figures on just how many operators there are, but there are literally thousands of oil producers. I know of no major industry that has a wider distribution of companies that are involved, or where there is a less concentration.

Senator GOLDWATER. Would you have any figures available that would show the percentage of small operators to the so-called large operators?

Mr. STANLEY. Yes. There are statistics that are prepared by the Chase-Manhattan Bank which continuously reviews 35 oil companies, which are by and large the largest companies. Those 35 companies produce approximately 60 percent of the crude oil produced in this country. The other 40 percent is in the hands, as I said, of literally thousands of producers. The largest producer, I believe, in this country accounts for approximately 6 percent of the total production, and if you contrast that with some other industries like steel or motors, or tobacco—I have the figures on that; the largest automobile producer produces 52 percent of the automobiles; largest steel producer, 34 percent; largest tobacco, 33 percent.

As I said, I know of no major industry that has a lower degree of concentration.

Senator GOLDWATER. So the small operator, the small-business man in the oilfield, is a very important adjunct to the entire oil economy of this country; is that correct?

Mr. STANLEY. I am sure there is no doubt of it.

Senator GOLDWATER. Would you say that the small producer could live without this percentage depletion for tax purposes?

Mr. STANLEY. I think that without depletion laws that many, if not most of all small producers, would be driven out of the business and would be forced to sell their properties, or at least to consider very carefully the making of any additional investments.

Senator GOLDWATER. Would any of the rest of you care to comment on this approach?

Mr. HARBERGER. I think that the concept of what would happen immediately when a particular tax situation changes should be distinguished from what would happen when the new norm is reached. Naturally, in any initial situation there are shocks and disturbances, and they should be studied, too, but I think we mainly want the long-run picture of what will happen without percentage depletion, and with a capital-gains basis, which was what Mr. Stanley, referred to in his paper. With the capital-gains basis it would be true that these small producers on discovering a well would sell it to somebody else, so that he could get a higher cost depletion basis.

Senator GOLDWATER. Isn't that pretty much the operating mode of the small operator today?

Mr. STANLEY. Senator, I would say that the small operator today values very highly his oil production that he has and that he tends to hold onto it. However, and that is just, I think, a normal instinct; however, in determining his financial policy he always recognizes the fact that he has the alternative of selling out and in many cases, you can't pick up an oil journal today hardly without finding where there are sales that have been made. Let me point out one advantage of that: The minute that that property gets in the hands of a new purchaser he has a cost-depletion basis that normally is in excess of any percentage depletion that we are talking about.

Senator GOLDWATER. Had you finished, Professor Harberger?

Mr. HARBERGER. I wanted to say that if this sort of thing happens, the sort of thing Mr. Stanley just described, it would happen much more if we took percentage depletion off and left the capital-gains treatment the way it is.

But if the capital-gains tax and the rate of tax on corporate income were brought into equality, it just wouldn't matter. If you sold for capital gains or retained for income, your judgments would be simply matters of financial policy. If you want to get a lot of money in a hurry you sell your wells. If you are willing to take it over time, then you keep them.

Senator GOLDWATER. This is not clear in my mind. It might not be clear in others. Do you contain in that argument the thought that if the depletion allowance were removed from the oil industry that we would be developing more large companies; we would be concentrating the control of oil production more and more within a few big companies?

Mr. HARBERGER. It is my contention that wouldn't happen.

Senator GOLDWATER. That wouldn't happen?

Mr. HARBERGER. That is right.

Senator GOLDWATER. I misunderstood you. I understood you to say that the small producer would be, I wouldn't use the word "forced," but he would be inclined to sell.

Mr. HARBERGER. The small producer would be inclined to sell if we left capital gains treatment the way it is and took away percentage depletion, but even if he is inclined to sell that doesn't mean we cannot get a division of labor. You have a company whose business is exploring, and its product is a successful well. When it finishes its business it gets a product which it sells and goes on about its business. This is the picture I would have of a small producer or small explorer.

On the other hand, if you have somebody who wants to be in the business of producing, he can buy successful wells, large or small, and produce out of them and, indeed, a small company could explore, sell its successes for capital gains, and buy somebody elses' successes and produce with them. It would be a little complicated, but there is no significant economic loss involved in that sort of trading.

Senator GOLDWATER. Might there not be a rather serious economic loss to this industry if we completely discourage the new small investor, the new small producer, by taking off the depletion tax? I mean the depletion allowance, pardon me.

Mr. HARBERGER. I do believe that the small producer is at a serious disadvantage, even at the present time. The reason for the serious disadvantage is that if you get a company—take General Motors, for example; General Motors——

Senator GOLDWATER. We are trying to take them over in the other building right now.

Mr. HARBERGER. I don't believe General Motors is engaged in the oil business in any sense, but General Motors is a company with a large net income, and that means that all of the expenses it would have, and all of the dry-hole costs that would come from any operation in oil exploration could always be offset against taxes at a rate of 52 percent. If you get somebody coming in who doesn't have any capital, he doesn't have that, and that is there under the present law, it is going to be there forever. Oil exploration, with these expensing privileges that go with it, is near a monopoly of people who have net income to do it on, and the people who go in without any net income against which to offset their expenses are in a very, very less favored position. This is a situation that I don't think can be changed without completely altering the expensing provisions which I think have merit on their own score. Therefore, I would suggest that we just take it as a fact, and be prepared as society to see the people who engage in this risky business be people who have net income to devote to the business of exploration.

Senator GOLDWATER. Of course, you also have that little fellow who wants to do it, and I don't think we can accept anything as a fact that would deny any American the right to risk his money if he wants to.

Mr. NELSON. Might I make a comment on that, please? It seems to me this involves in part the familiar problem of who is the small producer. One thing that has been assumed here that I wouldn't assume at this stage is that we are dealing with a corporation paying an income tax of 52 percent. Actually I think a number of producers or financiers of production are small in the sense that they have been involved in very few oil wells, but are not so small in the sense that the reason they are there is that they have a 91 percent income-tax rate. Frankly, I don't think the United States would be in any competitive difficulty or general difficulty if a few of the people who are

now in oil wells, because of the 91 percent rate on their normal incomes, were out of oil wells. That is a group I think could very well go into other fields of endeavor.

Senator GOLDWATER. You find that same situation true in agriculture and cattle raising where you have wealthy oilmen getting in that field.

Mr. NELSON. It is a problem.

The second thing I would like to bring out is that, you could certainly revive a group that is really small business—the small grocers—by some kind of tax arrangement.

There are many more small grocers than small oilmen in this country.

Senator GOLDWATER. We are talking about small business. It is always a matter of comparison what is small. What is small in Texas would be awfully big, not in Arizona but, say in Missouri.

Do any of the rest of you have any comments on this?

Mr. LAMBERT. Senator Goldwater, Professor Nelson brought out the case of the small grocer. My sympathies extend to him but I want to point out the essential difference between the small grocer and the small producer. The grocer is selling an inventory which he can replace at will and known value. The oil producer, on the other hand, is liquidating his capital, unit by unit. Professor Harberger illustrated the case of the small producer discovering a field, and selling it. Every producer is selling his same asset unit by unit when he produces it, but he is still liquidating or converting a capital asset.

To me the point that follows from there is that Professor Harberger just illustrated the hazards of making any change. Professor Harberger points out the justice in his mind of eliminating percentage depletion. Then he goes to the necessity for eliminating capital gains tax. Then what do you do about people who don't have to realize capital gains, because they don't have to liquidate?

You start a chain reaction that we don't know where it will lead, but this extends into so many ramifications of our taxing structure that the purpose of this subcommittee, which is to investigate methods producing stability and growth, I think should really look very, very carefully at it.

Senator GOLDWATER. That is all I have, Mr. Chairman.

Mr. MILLS. Did you have something you wanted to say, Mr. Fernald?

Mr. FERNALD. Yes, sir.

Practically all this discussion has been on the subject of oil rather than mines. There are, however, a couple of points that I would like, if I might, to speak of from our general mining standpoint.

In some of the papers presented to this subcommittee reference has been made to statements or tabulations presented by Treasury representatives in hearings on the revenue revision in 1950. As I pointed out in my statement in those hearings, on pages 371 to 376 in volume 1, those statements, or tabulations, do not correctly show the depletion allowances necessary to recover original costs as compared with percentage depletion allowable. Their showing was generally comparison of percentage depletion allowances with the amounts allowable on the remaining adjusted basis for the depletable properties. That adjusted basis represented the amount remaining after it had been re-

duced by percentage depletion theretofore allowable or by any cost depletion theretofore allowable, regardless of whether such allowable amounts did or did not represent any actual recoveries out of otherwise taxable income.

How serious this can be is indicated by a tabulation I there presented of Treasury statistics of income, showing that for some years one-half to two-thirds of all depletion deductions were on tax returns with no net income.

The Treasury statements of 1950 are thus no reliable indication of the amounts of cost depletion which would be necessary for recovery of cost for the particular producing properties they involved, to say nothing of the expenditures and losses in search for and development of others.

That bears on some of the discussion you have had here about the ability to deduct expenses you made. Well, you cannot deduct them if you don't have income. You have got an allowance for depletion, and it doesn't do you any good if you don't have income, and I know that there are some Arizona mines that don't have income every year, so they can get the benefit of all this.

I don't want in any way to minimize certain conditions that may exist, but they may not regularly exist. I wish I knew where I could put my money into a new discovery in your State, or some others, where I could be assured the average made by the profitable mines of the country. I would just love that, if you could tell me just where to do it.

Now, another point: Similarly the Treasury figures cited in Professor Nelson's paper, page 473, as to sulfur, seem to be misleading. In the assemblage of these figures, which are stated to have their source in Moody's Manual and special tabulation of the Bureau, we may assume that the relatively small amount for exploration expenditures by the three companies covered represented a total of all the items which were found to be separately stated as representing exploration expense. There seems no reason to believe this would represent the total of all the expenditures for exploration which have been made by these companies, including those which have been capitalized as part of the cost of properties, those which have been included in losses, and others which have not been separately stated.

In any event, presumably it would not include all the expenditures of these companies in search for, development of, and acquisition of additional properties during the periods under review. We are confident they do not warrant the inferences which seem to have been drawn from them.

In that connection, I have a letter addressed to you, Mr. Chairman, from Mr. Langbourne M. Williams ,president of the Freeport Sulphur Co., which gives support to my conclusion which I would like to offer for the record.

Mr. Mills. Mr. Fernald, I think this letter addressed to me should appear at this point in the record. It is from Mr. Langbourne M. Williams, who is president of the Freeport Sulphur Co. He wants to clarify some points that have been raised by some of the panelists.

If there is no objection, we will insert it at this point in the record.

(The letter is as follows:)

DECEMBER 7, 1955.

Hon. WILBUR D. MILLS,
Chairman, Subcommittee on Tax Policy,
House of Representatives, Washington, D. C.

DEAR MR. MILLS: In view of the fact that the depletion allowance for sulfur was brought up for discussion in some of the papers of the panelists appearing before the Subcommittee on Tax Policy, I wish respectfully to submit for the consideration of the subcommittee the following comments on this subject.

The 23-percent depletion allowance for sulfur has been in effect for many years. It was adopted as a more workable substitute for discovery depletion, which Congress established in 1918 in recognition of the principle that a mineral deposit is essentially capital and therefore the sale of the mineral should not be taxed as if it were income. The technicalities in determining discovery value were very great, and percentage depletion was therefore substituted, first for oil and gas, later for sulfur and other minerals. The whole theory, as well as the specific rates of percentage depletion, have been argued and reviewed by Congress many times since they were first legislated. Each time Congress has been convinced that maintaining the 23-percent rate for sulfur was in the public interest.

Percentage depletion furnishes a powerful incentive to individuals and corporations to take the risks which the search for mineral deposits has always involved. In effect, the rewards derived from a successful discovery tend to offset the losses sustained from unsuccessful prospects. The wisdom of this congressional policy of encouraging mineral exploration is demonstrated, in the case of sulfur, by the extent to which production of sulfur has been able through the years to keep pace with the mounting demand by the Nation's industry and agriculture for this indispensable material. During World War II, for example, sulfur not only was never rationed or allocated but substantial amounts were exported to our allies.

Freeport Sulphur Co. is one of the companies which mine sulfur by the Frasch process from salt dome deposits on the gulf coast of Texas and Louisiana. These deposits account for about four-fifths of the Nation's total sulfur supply. The record of exploration and development of Freeport in the past 5 years provides an instance of how, under the incentive of percentage depletion, more of this strategic material is being made available to the Nation.

Early in 1951 a strong effort was made to reduce the depletion allowances, but the Ways and Means Committee voted to reject the proposed reductions and to maintain the time-honored rate for sulfur. At that time Freeport went ahead with the largest exploration and development program it had ever undertaken. The company proceeded to spend more than $30 million in finding and developing new sulfur deposits. This program resulted in the development of four new mines and the initiation of plans to develop a fifth. It added substantially to the Nation's sulfur reserves and productive capacity. It demonstrated that the depletion incentive fulfills the intent of Congress to encourage the mining industry to spend large sums of money under conditions of great risk.

The risks involved in exploration for and development of sulfur deposits are seldom, if ever, encountered by other branches of the mining industry, and these risks are increasing year by year. Of the approximately 250 salt domes which have been discovered in the gulf coast region of the United States, fewer than 10 percent have been found to contain commercial sulfur. Only 19 have produced sulfur commercially, and of these 6 have been exhausted. Since almost every salt dome within the land area of Texas and Louisiana, including the Louisiana marshes, has now been explored, the open waters of the Gulf of Mexico provide virtually the only possibility now remaining for finding important new United States reserves. While the cost of recent exploration in the Louisiana marshes has been high, the cost of exploring for sulfur in the open gulf will be much more expensive.

To establish the existence of a commercial sulfur deposit it is necessary to drill not just one, or even several, but a large number of exploratory wells. This fact, of course, adds to the costliness of sulfur exploration and increases the stakes that must be risked. Moreover, the risks involved in sulfur mining do not end when a deposit is found. Because of the uncertainties inherent in mining by the Frasch process, there is no way of telling whether or not a deposit can be mined commercially until a complete mining plant has been constructed and placed in operation. This means that Freeport has to risk not just exploration money but development money as well before it can be sure that com-

mercial production can be obtained. The cost of construction of one mining plant alone was approximately $13 million.

In several instances in the past, experienced operators have constructed sulfur mining plants only to find that commercial production was unattainable. The latest example occurred only last year. A company formed in Texas in 1952 built a plant to mine a portion of Long Point salt dome. The plant was completed and attempts to mine the deposit were begun in June 1954. Despite the company's efforts, no sulfur was produced, and in August 1955, the company went into bankruptcy.

Looking toward the future, the design and erection of plants to mine sulfur in the open waters of the Gulf of Mexico will involve a multitude of problems for which solutions are yet to be found. The domes which are known to lie off the coasts of Texas and Louisiana are in some cases as far as 45 miles from shore and under as much as 75 feet of water. The facilities, if actually installed, must include a powerplant large enough to supply several million gallons of superheated water a day, as well as shops, warehouses, auxiliary buildings, and living accommodations. They will be exposed to the violent action of the wind and waves and will have to withstand the unbroken force of annual tropical hurricanes. Very few business enterprises face this kind of risk.

Whatever the risk and whatever the cost, the continuing search for and development of new sulfur reserves must go on because sulfur is one of the indispensable raw materials of our economy. Sulfur is employed in the production of virtually everything we eat, wear, or use, and indeed the use of sulfur is so widespread in agriculture and industry that an index of sulfur consumption is, in effect, a measure of our national growth. Sulfur plays an important role in the Nation's production of food and other agricultural products through its use in the manufacture of fertilizers and insecticides. It is employed extensively throughout the chemical industry. It is used in the production of pulp and paper for our newspapers, magazines, and books. It is necessary for the production of aviation fuel, lubricants, and many other petroleum products. It is essential in the making of steel and in the production of automobile tires, storage batteries, and numerous plastic products. In fact, it would be virtually impossible to produce or operate a modern automobile or aircraft without sulfur.

Although sulfur is used most generally as a chemical tool and seldom can be seen in the final product, it is difficult to think of anything which does not at some point in its production involve the use of sulfur. Without adequate supplies of sulfur, our present economy could not exist, nor would we be able to defend ourselves if we should become involved in another great war.

Sulfur is one of the strategic materials which this country has in adequate supply, a condition attributable in no small degree to the incentive afforded by the sulfur-depletion allowance. As the use of sulfur increases, so must sulfur production and known reserves be increased. The President's Materials Policy Commission estimates that twice the amount of sulfur will probably be required in 1975 as in 1950. To attain this goal producers must solve many new technological problems and risk far greater amounts of capital than ever before. Certainly nothing should be done to reduce the incentive which makes people willing to take such risks and thus makes it possible for the Nation to have an adequate supply of this important material.

Faithfully yours,

LANGBOURNE M. WILLIAMS.

JEFFERSON LAKE SULPHUR CO.,
New Orleans 12, December 9, 1955.

Re Federal Tax Policy for Economic Growth and Stability.

Hon. WILBUR D. MILLS,
Chairman, Subcommittee on Tax Policy,
House Office Building, Washington, D. C.

DEAR MR. CHAIRMAN: Reference is made to the above hearing held by your committee, which has just come to our attention, and we request that this letter be filed in the record as a statement by Jefferson Lake Sulphur Co.

Reference is more specifically made to the statement filed in the record of the above hearing by Prof. James R. Nelson, and entitled "Percentage Depletion and National Security," appearing on pages 472–473 of the printed report Federal Tax Policy for Economic Growth and Stability, November 9, 1955.

Jefferson Lake Sulphur Co. is currently the third largest producer of sulfur, principally by the Frasch hot-water process, and operating 2 of said plants in the State of Texas, and 1 in the State of Louisiana. The company also operates a small plant in Wyoming, reducing hydrogen sulfide from sour natural gas to elemental sulfur.

Sulfur, as you know, is an element (commonly called a mineral), which is vital to industry and agriculture, both in peacetime and in war. It finds its way directly or indirectly into practically every manufactured article, and is indispensable to the chemical industry and the agricultural industry, particularly for the manufacture of fertilizers.

Professor Nelson states that the statutory percentage depletion allowance of 23 percent on sulfur should in effect be abandoned. He submits a compilation of figures compiled during the period 1930 through 1948, and apparently through an attempted analysis of these figures sets forth that the sulfur industry expended an average of $369,000 per year for exploration purposes.

We make the following observations:

(*a*) The figures are not correct; they do not reflect the exploration which is done on properties which are subsequently held for a period of years, and on which the original exploration becomes a capitalized item.

(*b*) They do not reflect what in effect is exploration by the drilling of numerous outpost wells on certain of the leases and areas situated on domes which are in actual production, and which wells reveal no mineralization, and are in the parlance of the oil and gas business "dry wells."

(*c*) The period with which Professor Nelson treats was largely a so-called depression era, and during the period 1940 through 1946 a greatly restricted era for the utilization of materials and supplies and manpower not absolutely needed. (The Second World War era.)

(*d*) There has been a definite transition in the whole sulfur industry, and during the period from 1950 to the present time there has been more exploration in an attempt to locate additional sulfur reserves for the national security than in any similar period in history.

(*e*) Costs of this type of work have soared, and for the smaller companies becomes almost prohibitive, based on geographic and other attendent hazards.

(*f*) The occurrence of sulfur in the caprock and the shallow domes in the gulf coast area of Louisiana and Texas has been scarce, and has required in many instances a tremendous number of exploration wells in order to prove a relatively small tonnage of sulfur in place which could be commercially mined, and which in many instances has been marginal.

(*g*) Sulfur today is virtually indispensable to the national security; additional reserves must be proven within the borders of the United States; as stated above the shallow domes on land containing sulfur we believe are all known.

(*h*) Large reserves for the future must be found on the Continental Shelf—in the Gulf of Mexico—probably under water 40, 50, or 100 feet deep; this is the area which holds a promise of giving the United States its sulfur reserves during the future span of years, and giving it national security and economic stability insofar as this mineral is concerned.

(*i*) Drilling sulfur exploration wells in the Gulf of Mexico, and the erection of facilities for the production of sulfur will cost unprecedented millions of dollars; and actual cost of operation will greatly exceed the average costs attendant to similar operations on land. In addition, these future operations pose new hazards, all of which will be costly.

We submit that all recommendations by this committee should be definitely to the effect that the 23-percent depletion allowance on sulfur be retained in the interest of the national security and economic welfare of the United States.

Respectfully submitted.

EUGENE H. WALET, Jr., *President.*

Mr. MILLS. Mr. Ture, of the staff of the Joint Committee on the Economic Report, desires to interrogate the panel.

Mr. TURE. I wonder if we could bring into a little sharper perspective what we mean when we talk about resource need.

Several of the panelists today have presented estimates of what the need for various types of mineral resources over the next X number of years will be. We have heard from other panelists who have indicated that there will be a need for a certain number of

billions of dollars of outlays for plant and equipment. Other panelists have suggested that we will have a need over the next, say, 10 years, for a certain amount of increase in our outlays for consumption. In other words, virtually anyone with an economic interest in any particular type of economic activity can, at the drop of a hat, tell you what the need of the economy is for the product of his activity. I think we must bear in mind that we have a scarce amount of resources at any given moment of time. Shouldn't we, therefore, talk about need in the relative sense, not in absolute terms. I think this—I am addressing this as a question to Professor Harberger, but I would appreciate the comments of the other panelists—is what you mean when you talk about efficient use of resources, is it not?

Mr. HARBERGER. Yes.

Mr. TURE. I would like to develop this question of waste in use of resources.

Dr. Smith, could you repeat those figures that you mentioned during that colloquy with Professor Harberger about total outlays and total barrels of production?

Mr. SMITH. Yes. For as many years as I could find—and, of course, the subcommittee ought to be in a position to have the research done over a longer period of time, but the figures that I could obtain for the past 4 years indicate that so far as exploration and development are concerned, not talking about refining, transportation, etc., but talking about exploration and development, the industry in the United States spent approximately $14.4 billion, and found about 15.9 billion barrels of oil.

Mr. TURE. What would be, on the average, the value of that total amount of oil found?

Mr. SMITH. It will easily sell in the ground for $1. I am conservative when I say a dollar. Of course, you understand that quality varies the price, but I would say $1 a barrel average. That would be conservative.

Mr. TURE. For purposes of illustrating the point, would it be fair to say that over that period the industry spent $14.4 billion and got a product at the first production stage—in other words, the immediate product of exploration—of $15.9 billion?

Mr. SMITH. That is in the ground.

Mr. TURE. If my very hasty division is correct, it shows a rate of return on that investment of about 10 percent. Does that sound reasonably correct?

If you get $15.9 billion back on an outlay of $14.4 billion, doesn't this represent a net return in the order of magnitude of about 10 percent?

Mr. NELSON. Aren't you getting barrels back?

Mr. LAMBERT. Ignoring the present worth factor, I think that is correct.

Mr. TURE. I am looking at a table which was prepared by the Federal Trade Commission, with SEC data, which shows the net rate of return before taxes of manufacturing corporations in the United States between the years 1936 and 1955. Take the years 1952, 1953, and 1954, and the first and second quarters of 1955. The before tax rates of return on capital outlays in the manufacturing industries were: For 1952, 21.8 percent; for 1953, 22.3 percent; for 1954, 18.2 percent; the first quarter of 1955, 22.3 percent; second quarter of 1955, 25 percent.

Now, in developing this concept of waste of capital resources, suppose, Dr. Smith, that you had this $14.4 billion to invest, and here is one area of the economy, manufacturing industry, where presumably, if you could get in without any difficulty, you could earn a return at, say, the second quarter of 1955 rate of 25 percent. Wouldn't you consider it wasteful to use that $14.4 billion to finance a return of $15.9 billion?

Mr. SMITH. I think, Mr. Ture, we may be overlooking this difference: These folks who go in and look for oil, they are not trying for any specific percent. They are trying for as much as they can possibly make out of it, and some of them do hit, no question about that, and 10 percent is a ridiculously low figure for them.

We are talking, when we talk about $14.4 billion worth of exploration and development expenditures, finding 15.9 billion barrels of oil, which we roughly value at a dollar a barrel in place. We are talking about a 4-year period, and we are talking about the industry as a whole.

Personally, I wouldn't put a nickel in the oil industry, because in the first place I don't know anything about it—I mean to go out and look for it—in the second place, I just don't want to take that much risk on it, but there are fellows who are built differently, and they will go after it.

Mr. TURE. I wonder if the situation is this: That insofar as anything in public policy, particularly in this connection tax policy, encourages people to go out and take this chance, when they can see that taking the aggregate of operations, their chances boil down to about a 10 percent rate of return, whereas if they took the same resources and took approximately the same chances, and went into, say, manufacturing industry, their return would be 25 percent—doesn't a public policy that encourages them to do that encourage waste of resources? It turns on the value of the product that the society as a whole places on the product of economic activity.

Mr. SMITH. Again, we may be overlooking value from the standpoint of national security, and I don't know how we are going to appraise that.

Secondly, I think we may be overlooking this, that that is a discounted value that I have given you on oil. It doesn't always come out in one day and you go sell it. It is discounted. In other words, when an operator comes in our bank to borrow against oil he has in the ground, which he has sold to some major company, he pledges the runs and we get the checks directly from the major company. That oil doesn't all come out at once, you see, so in calculating how much we will lend him we simply discount the future runs over quite a period of time, so that dollar is in a sense misleading.

I think also we are overlooking—and this is No. 3—that you have an industry that is different in its risk factor from a manufacturing industry, or some other type of industry, and that the reason you get these figures that seem to indicate your point is the very fact that everybody doesn't hit, and there is that chance factor there.

I brought the figures in, sir, only to raise a question with Professor Harberger about his statement, which was a serious charge against the industry, that it is spending $1.95 to get $1 in return.

Mr. TURE. Pardon me for interrupting you. I am not necessarily taking Professor Harberger's side in this question, but I don't think the charge he made was a charge against the industry.

Mr. SMITH. But at the bottom of page 443 he says that.

Mr. TURE. No. He is leveling a charge against the tax law, not against the industry. I don't think he would for a moment suggest that given the tax law as it now stands, that the industry should say "No, we will not take advantage to the fullest extent of these tax provisions."

If they were to make a statement like that I think then Professor Harberger would say that they are subject to a charge.

Mr. SMITH. Mr. Ture, whether he is charging it against the industry or against the tax law as it exists, the point still holds true that in the world of economic reality it doesn't happen that way, and isn't happening that way. They are not spending $1.95 to get $1 back.

Mr. TURE. They seem to be spending $14.4 billion to get $15.9 billion which appears to be on the same order, though not so extreme as that Professor Harberger suggested.

Mr. SMITH. If figures are inaccurate, I think it is mandatory upon this subcommittee to find the figures on that, because I think it is an important point, and not accept Professor Harberger's algebraic formula.

Mr. TURE. I wonder if we can proceed to another point. It seems to me that in the context of this discussion one may very well conclude that something is to be desired with respect to the effectiveness with which we are using resources in the national-resource area. On the other hand, there is the caveat which you have suggested—it seems to me a very pertinent one—that we must be very mindful of our national-security requirements. I think that there is nothing that any of us can say except "Amen" to that.

Now, Professor Nelson suggested that if we actually have a situation of a wasting resource, which cannot be effectively stockpiled, or can be stockpiled only at some extraordinary expense, that maybe we ought to be developing a policy which will encourage exploration for these resources, but which will discourage the use of them.

Now, do you think that the present tax provisions will meet that test, which seems to me to be singularly appropriate, particularly when we are talking about oil?

Mr. SMITH. Well, I think that Professor Harberger has overlooked the fact that we aren't just wildly producing oil in this country; that most of the States that are major producers of oil have limitations on what can be produced. I see ahead—and, of course, I am basing my look upon what the President's Materials Policy Commission reported—I can see ahead by 1975—as rapidly as our population is growing, and as much as we are industrializing, and as great a need as we will have for energy sources—not less than 60 billion barrels of reserves needed by 1975, just to maintain the margin of safety that we may have right now.

I don't think anybody, Mr. Ture, can tell you the value—in what really counts in a world such as the one we are living now—of having 60 billion barrels of oil. I just can't see anybody doing that.

Mr. TURE. I would be perfectly willing to believe that we must have any given number of barrels of oil on hand, or potentially on hand, in

a very short period of time in order to meet the threat of another war. But I wonder whether the greater our required reserves for defense purposes the higher ought not to be the price per gallon of gasoline, and per quart of oil, so that I will not be driving my very gasoline-thirsty automobile on the streets on pleasure jaunts, but rather will be holding back so that we can conserve this oil for something more important than my driving back and forth.

I wonder whether or not our present tax provisions don't make it possible for me to buy a gallon of gasoline out in Maryland at thirty-three-and-some-tenths cents per gallon when I really ought to be paying, if we take full account of our defense needs, perhaps 70 cents or perhaps $1 per gallon for gasoline.

Mr. SMITH. May I say some more? It is, I think, rather supposed, although not definitely proved, that the demand for petroleum and petroleum products is fairly inelastic, and if we left stimulus to exploration and production solely to price and didn't keep any restrictions on the amount produced, I don't know how much would be consumed at a lower price—probably not a great deal more, if there were absolutely inelastic demand.

Mr. TURE. Do you think much less would be consumed at a considerably higher price?

Mr. SMITH. I think less would be because I don't think demand is absolutely inelastic. I think less would be consumed, but I am thinking of the purpose of this subcommittee's investigation: What effect would there be upon the economy, upon growth and stability? Wouldn't it have a tremendously disturbing force if we did it?

Mr. NELSON. It seems to me what is involved there is something that is unfortunately with us in our defense taxload originally. Defense does have an effect on our growth and stability. We are diverting funds for resources that we would like to conserve.

Mr. SMITH. That depends pretty largely upon what the Kremlin folks do, doesn't it?

Mr. NELSON. It is certainly not anything we dreamed up ourselves. It is what we are stuck with, because of this Persian Gulf situation—a very bad location compared to what we would like to have in the matter of oil reserves.

Just to take percentage depletion—and this is thrown out as a possibility, not as a suggestion—you could very well have a system of zero percent the first year, 1 percent the second, which would extend the ratio of reserves. In other words, it would change your whole time-discounting horizon because you would get a much larger tax reduction on later years than on earlier years. That would be one way of getting at this reserve problem rather than getting at it by a system which awards only a flat discount when you sell it, which does not build up reserves.

Mr. TURE. Thank you.

Mr. MILLS. The chairman has been very quiet. I thought that members of the subcommittee and members of the panel would discuss this subject matter enough that by the time 5 o'clock arrived the chairman could ask a question or two and we would find the panel in complete accord on a lot of points. Let me see if we are in accord on any points.

First of all, existing law provides for differential treatment, does it not, for the natural-resources industry, or the extractive industries of the country? Do you agree with that?

Mr. FERNALD. Yes.

Mr. MILLS. That has been stated by a great number of the members of the panel.

Are we in agreement that there is some economic justification, or some necessity for economic growth purposes for some differential in favor of the extractive industry? Mr. Harberger shakes his head; Mr. Gray shakes his head; Mr. Nelson shakes his head; and we have four nods of approval.

Let us see, then, if there is any justification from the point of view of national defense. Is there general agreement that we are justified in having a differential in tax law favorable to the extractive industry from the point of view of national defense?

Mr. Harberger again shakes his head. Mr. Gray shakes his head.

Mr. NELSON. There are two different questions: a differential-tax law, and this particular tax situation we are discussing. I would like to distinguish between them. I would like to vote "no" on the second, and leave the first one open. That isn't really what we are talking about.

Mr. MILLS. But on the broader question of whether or not a differential in tax law is justified because of peculiar needs of national defense, you say that there may be some justification?

Mr. NELSON. There might be situations in which some particular tax law would be necessary; yes, sir.

Mr. MILLS. And you say the same?

Mr. GRAY. Let me put it this way: We are all aware of the national-defense situation. There is no argument about that. We are, I think, somewhat in disagreement as to how to do that and my general position is that it can be done better other ways than through the tax system.

Mr. MILLS. When national defense requires, we are justified, in your opinion, in using some means of making adjustments that will bring up the production in extractive industries as needed?

Mr. GRAY. Yes; by other means.

Mr. MILLS. Now, on the basis of that, when do you begin? After the national emergency arises, or do you vote such a program as a continuing affair? Would you say regardless of what it is, something might be justified from the viewpoint of national defense for the extractive industry? When do we do it? Do we do it as a continuing proposition or do we do it just as the emergency arises?

Mr. GRAY. My answer to that would be we do the very best we can, trying to anticipate the national-defense needs and what is necessary to meet those needs, and then we try to figure out the cheapest and best way to do the job.

Mr. MILLS. My point is this, Mr. Gray: I think there is more agreement among us perhaps than you think there is. We come to the point that on the basis of national defense in some instances it is necessary for the Government to take some action. You think there are probably better ways of doing it than by differential in tax laws. Regardless of that, whatever approach is taken, when do you grant that differential treatment, taxwise or otherwise, in order to accomplish the need for national defense? Do you do it just at the time

the extreme emergency situation develops, or do you do it as a continuing proposition so that when the emergency arises you may be in a position in the extractive industry promptly to meet emergency requirements?

Mr. GRAY. I think you must anticipate as best you can, be forewarned of these matters, and do things ahead of time to meet the situation, if possible.

Mr. MILLS. If it developed that it was necessary to have a continuing program of some sort, a differential tax law or otherwise, in order to have the extractive industry in position to meet the needs of the national emergency when they arose, you would say then that it would be a continuing program?

Mr. GRAY. Yes.

Mr. MILLS. Would you agree, Mr. Harberger?

Mr. HARBERGER. Yes.

Mr. MILLS. Would you agree, Mr. Nelson?

Mr. NELSON. Yes.

Mr. MILLS. I think we have come a long way. You gentlemen will agree with that. The four of you now from industry will agree to that.

Mr. LAMBERT. Yes.

Mr. NELSON. The term "differential," of course, can apply either way, differentially favorable or unfavorable.

Mr. MILLS. Oh, yes, I understand, but let's see if we can get any agreement in that area now: We have, I think, pretty well today approached the question of the differential that exists in law on the basis of the need for it, and from several points of view. Some have discussed the economic point of view, some have discussed the national defense point of view. What is it we are dealing with anyway, Mr. Fernald, in the extractive industry? Are we dealing with capital goods or not?

Mr. FERNALD. You are dealing with the whole fabric of our entire life dealing with the mineral industry. All our electrical industry is dependent on copper.

Mr. MILLS. I understand, but what kind of goods are we dealing with? Are they capital goods when we mine something, when it comes from underneath the ground, whether it is coal, or manganese, or something else? What is it we are selling when we mine or produce oil? Are we selling a capital product or are we selling something else? What are we selling?

Mr. FERNALD. We are selling part of our capital asset.

Mr. MILLS. Is it agreed that it is a capital asset, properly? Does everybody agree to that?

Then I wonder if we would be justified under any tax policy of suggesting that the proceeds of the sale of a capital asset should, regardless, be taxed at normal income rates? Would anybody suggest that?

Mr. NELSON. What do you define as cost; nothing? There is no cost involved in finding this? Everything is taxed?

Mr. MILLS. I am laying aside these things. I am talking about when we reach a point of net return, we are going to apply a rate of tax. Shall that rate of tax after costs have been deducted—I will go with you that far—shall that net return be taxed as normal income? Do you think it should be?

Mr. SMITH. No.

Mr. HARBERGER. Yes.

Mr. MILLS. I am surprised now. Are there other examples in tax law where your result is attained?

Mr. HARBERGER. I think everybody would agree that a Caterpillar tractor is capital asset, and the Caterpillar Tractor Co. spends a certain amount of money to produce Caterpillar tractors, and it is taxed at normal income rates on the difference between what it gets and what it spends.

Mr. MILLS. Now, what is the difference?

Mr. STANLEY. I think there is a very fundamental difference, when they sell you a Caterpillar tractor. They are not selling you part of their land and part of their building. When you have a natural resource, so far as the owner of the property is concerned, that is being exhausted and that is being depleted. You are disposing of his capital.

Mr. MILLS. Mr. Nelson?

Mr. NELSON. I assume that for Caterpillar Tractor, as for every other manufacturer, depreciation is part of their annual costs. They are selling part of their land and building as much as anybody else. You buy with a tractor some wear and tear on the machinery and property. It seems to me that this other question, once you use up oil or copper you can't replace it, actually throws the light on the defense question in a very clear way; namely, don't you have a special problem of restricting use of an irreplaceable resource that you don't have with the Caterpillar tractor? I am not worried that if we get a Caterpillar tractor today and dump it over a cliff, we won't have one tomorrow.

Mr. MILLS. Are you and Professor Harberger saying, Mr. Nelson, that even though this is property, and it is recognized as the particular property involved, being sold today as depleted, that there should be no recognition in the application of the income tax of the fact that you are disposing of a depletable product?

Mr. NELSON. Except insofar as you wipe the cost of discovering it off over the life of the property, in other words, as you would with the tractor. The difference might be that here you would do it on units of production rather than years of life. There might be some difference in that respect.

Mr. MILLS. You are opposing not so much the idea of depletion, I take it, in that answer, as you are the application of depletion with other things.

Mr. HARBERGER. I believe the principle that both Mr. Nelson and I would agree to is that depletion should be just like depreciation. There is a certain outlay and that outlay should be recovered before anybody gets any income, or in the process of getting income. This is exactly what cost depletion would do, but it is not what is done by percentage depletion. By percentage depletion, when you already have expensing of the costs of finding most of these deposits, you have a lot of expense and then you get percentage depletion in addition, so it is really an excessive allowance for the depleting nature of the property.

Mr. MILLS. But you would allow cost depletion for the extractive industry, then?

Mr. HARBERGER. Sure.

Mr. MILLS. You would do that?

Mr. HARBERGER. Sure.

Mr. SMITH. May I ask him a question?

Mr. MILLS. Yes.

Mr. SMITH. I think it will help you and help me, too.

I would like to ask whether he understands the principle of depreciation to be accepted generally to enable a business to get its capital cost back, or whether he understands the principle to be generally accepted for the purpose of enabling a business to continue in the operation that it has been in. There is a difference. If you say that it is for the purpose of enabling the business to continue to operate as a going concern, then you would be obliged to say that it is all right just to depreciate the amount that would be equal to replacement cost. When you get over into the oil industry, if you can devise some way to enable a fellow to get back a million barrels, or whatever the amount is he has depleted, and can assure him that particular cost, or assure the industry as a whole that by any technique of depreciation, I would like to know what it would be.

Mr. HARBERGER. I believe that this is this question of so-called replacement cost depreciation. I believe it has a real sense when we worry about the periods of great inflation, or deflation, and indeed, I think it is only because of the problems connected with inflation that there is any justification at all for a separate rate of taxation under capital gains, but for the moment let's not worry about inflation. There are other ways of taking care of that in tax laws.

For the moment, let's take a setup where we have a stable economy, but oil is getting increasingly hard to find, therefore increasingly more expensive, and now we have somebody who has several million barrels of oil in the ground as a standing inventory. As the price of oil rises, or it becomes more scarce, and he is permitted always to hold this standing inventory, that inventory is increasing in real value all the time, and he is paying no tax unless you tax him on the basis of cost input, and accordingly I am in favor of depreciating on the basis of cost in order to not provide the holders of these inventories with ever-increasing enhancement of the real purchasing power of those inventories.

Mr. SMITH. I would go along with him if we had a complete monopoly of the oil industry, just one great company for the whole United States. I would be willing to go along with him on that, I think, but it just doesn't operate that way.

Mr. MILLS. Now, you are for depletion, then, in some forms?

Mr. HARBERGER. Cost depletion.

Mr. MILLS. Is there an additional reason why you favor cost depletion over present depletion allowances other than that which you have mentioned?

Mr. HARBERGER. Other than what I just gave, the other one I cited before, that the present depletion allowance gives incentive for expansion of industries which means we use, for expansion of oil, resources that could be better used in making motors, etc.

Mr. MILLS. The cost depletion would remain the same?

Mr. HARBERGER. If the costs are equal in all these industries, then they are all on cost depletion. GM gets depreciation, the corner grocery gets it, everybody is in the same boat.

Mr. MILLS. You are still for cost depletion after considering the defense angle as well as the angle of economic growth?

Mr. HARBERGER. Yes. I am in favor of a tax setup which will treat all industries equally and then if we want special treatment for certain industries and special considerations for national defense grounds, there is every reason to look at each specific instance on its specific merits. I don't believe for a minute that the kinds of considerations on national defense grounds that would apply to petroleum, which is a wasting asset, that we have to discover, and where we don't know how long our supplies will last; I don't believe the same principle should apply to coal when everybody says we have got a thousand years' supply of that.

Mr. MILLS. Mr. Nelson?

Mr. NELSON. It would seem to me that the basic issue involved here is the question of whether with a given expenditure of effort and capital over the years, you get a highly fluctuating return in oil or not. The best general summary I have ever seen of the economics of this is contained in this volume. The National Petroleum Council, 1952, Petroleum Productive Capacity, and in this volume on page after page the council has stressed the straightforward proposition that the more money you put into petroleum, the more oil you get out. Here you have a graph, horizontal axis wells drilled in 1950, State by State, on the other axis, oil or gas discovered, State by State. You will see a correlation in those. The same thing is true taking exploratory footage drilled, including new oil, extensions, and revisions. This is a straightforward economic proposition. Once you run out of a certain economic reserve you put resources into the new one. This is the result. That is what you do with the tractor; you put new resources into machinery and get new machinery. The only special case here is one Mr. Smith mentioned, the very small producer is in a gambling position. He may put down a bunch of wildcat wells and get nothing. Let's face the problem frankly. Are there industries which are appropriate for small producers? The automobile industry apparently is not one. The second question, small producers not only will be thrown back by the possibility of loss, but attracted by the possibility of profit. That happened in the Klondike. They spent a lot of money, but had a lot of fun doing it.

I would say in general this is a straightforward proposition of putting so much oil in the ground and so much oil is found.

Mr. MILLS. Is there a differential economic effect in present depletion allowance as between oil companies, say—that seems to be the one we think of most when we talk about extractive industry—between large and small companies? This is what I am getting to: The fact that a company may well enjoy a depletion allowance of 27½ percent of its gross income. The smaller company enjoys a depletion allowance that represents even 50 percent of its net, say. The difference in dollars between the large and the small is what I am addressing myself to now.

Mr. Stanley, you represent a smaller independent, do you not?

Mr. STANLEY. Yes, sir.

Mr. MILLS. Is there a competitive disadvantage arising to the small company from the application of the depletion allowance as it now exists?

Mr. STANLEY. Mr. Mills, I would say that to a remarkable degree the application of the present percentage depletion law is relative to size, to the amount of production, between companies. I should emphasize that the depletion is computed on the basis of each individual property, and on an overall basis, I know of no distortion between the effect on the small company and the effect on the larger company.

Mr. MILLS. I wondered about this part: I have had some people in the oil business talk to me in the last year—maybe they are not in the oil business. They sell oil. Maybe they are not in the production end of it, but they complain about the fact that Standard Oil Co., for example, has adequate funds to advertise and cause me to believe that I get more mileage out of Esso than I do out of Gulf or whatever the competing oil might be, and part of the money used in that advertising campaign might well result from the fact that Standard Oil Co. enjoys depletion allowance because it is in the production of oil, whereas these people that have talked to me are not in the production of oil, and therefore have no backlog of extra financing that they can use to promote their product and that they are placed in an unfair position, and that the producers are given an advantageous position over them. I have had people in the oil business tell me that—are they right or wrong?

Mr. LAMBERT. I think they are wrong. The implication I gather from that question is that some marketeers have said to you that larger companies use funds derived from the depletion incentive for improper purposes in marketing.

Mr. MILLS. You said it exactly.

Mr. LAMBERT. I think that is just not so at all. Larger companies are required by necessities of their business to use their depletion incentive funds and the capital flowing therefrom in exploration and production and development.

Mr. MILLS. Required by whom?

Mr. LAMBERT. Required by the necessities of the business. The fund used in marketing and advertising, and so forth, flow from that branch of the activity, and there is no allocation of funds from one branch to the other, which permits this competitive advantage that they say.

Mr. MILLS. Is all of the 27 percent allowance which Standard Oil of California enjoys used in exploration?

Mr. LAMBERT. That and much more so.

Mr. MILLS. Is that typical?

Mr. LAMBERT. The Chase Bank figures that Mr. Stanley referred to show that for 35 representative companies in the industry in 1954, they spent an average per barrel of $1.76 on exploration and development. That $1.76 is related to production. The depletion allowance, based on that same production, was about 75 to 85 cents, so that they took all of the depletion and added a dollar from the other sources—maybe borrowed sources or equity and put it into exploration and development.

Mr. MILLS. Is their general agreement that that is the situation?

Mr. NELSON. How much was the expensing on top of that? That is from the standpoint of source of funds? $1.76 of which 75 cents would be depletion. Is expensing in that 75 cents?

Mr. LAMBERT. A part of the $1.76 was expensed.

Mr. NELSON. You have 75 cents plus.

Mr. LAMBERT. Yes. I do not mean all of the $1.76 was capitalized. I don't mean that.

Mr. MILLS. Mr. Stanley, since you represent a smaller oil company, I had better address this question to Mr. Lambert. Depletion allowance would be given the Standard Oil Co. of California if it developed oil in Venezuela; would it not?

Mr. LAMBERT. If we operated in Venezuela through a United States company it would; yes.

Mr. MILLS. What economic reason and justification is there for depletion allowance being extended to an American company for developments overseas?

Mr. LAMBERT. Well, I think a very, very basic reason.

Mr. MILLS. I need to be convinced on that part.

Mr. LAMBERT. It is part of our United States policy to encourage the venture of American private capital into foreign areas, and if our capital cannot go into a foreign area and be competitive with foreign capital, it just won't go, and I think it is the margin of the depletion allowance which permits American companies to be competitive.

Mr. MILLS. Now, Mr. Stanley, I want to talk to you a little bit, because you deal exclusively here in the United States.

Mr. STANLEY. Yes, sir.

Mr. MILLS. And down in Texas, they claim—and I imagine with some degree of justification—that they can produce less oil because there is so much more oil coming in from other places. Do you find any elements of that competition where you do business?

Mr. STANLEY. I have never been too greatly concerned about that situation, Mr. Mills. Actually, today there are approximately 1 million barrels of oil or its equivalent in products that are being imported into this country.

Mr. MILLS. You had better talk to Dr. Fleming about that.

Mr. STANLEY. There is difference of opinion. It revolves around questions of national defense, it revolves around questions of whether we augment our present supplies or whether we displace them.

I have never taken part in that controversy. I have largely been in California.

Mr. MILLS. I just wondered, whether as an independent oil producer you ought not become interested in that. Let me show you why: I do not want to talk about anybody who is not here, but Standard Oil Co.—it may not be California, it may not be New Jersey—but at least one of the Standard Oil companies in the United States may operate in Venezuela. They enjoy the same depletion allowance that Mr. Stanley enjoys in California. In addition to the depletion allowance being the same for that operation in Venezuela, there is a tax differential when the profits come back to the United States. It is not taxed at 52 percent as Mr. Stanley is taxed at 52, on whatever is left after he gets through with all these details, but it is taxed on 52 less 14, which would be 38, Mr. Stanley.

Mr. STANLEY. That is right.

Mr. MILLS. Is that in the interest of economic growth here in the United States in the oil industry or any other industry?

Mr. STANLEY. Mr. Mills, I have never gone into the question of foreign imports and I have no personal position on it. I am sure that

Congress in setting that differential has taken into account many factors that apply in offshore operations by American companies.

Mr. MILLS. No, sir; the Congress had not taken oil into consideration. That was not the reason it was done. It was done in order to develop certain minerals that we thought we needed in wartime in South America, Mr. Fernald, but not the oil industry. It just happens now that oil was developed in Venezuela by American companies. It gets the benefit of that tax differential. I want to know how it is in the economic interest of the United States, when that oil being imported from Venezuela is called to Dr. Fleming's attention as being a great threat to our national security. Mr. Smith, maybe you desire to comment on that.

Mr. SMITH. No, sir; I do not have any comment to make on it, except possibly to say that oil in Venezuela, or in Canada, is far more in the interest of our national security than oil, say, in Persia.

Mr. MILLS. During World War II, we found that manganese produced in Brazil was fine, but it just couldn't get here. About 65 shiploads were headed this way and about 2 of them got here in World War II. Now, I do not understand the economic justification for depletion allowances for oil produced in Venezuela. I do not understand the implications for defense needs when domestic companies make their case before Dr. Fleming entirely on the grounds of defense, and ask him to limit importation of oil from Venezuela.

If this depletion allowance for Venezuela is good and in the economic interest of the United States, and if the 14-percent tax differential is good, and in the economic interests of the United States, why do we then oppose receipt of the product that comes from that production, which we are stimulating in the economic interest of the United States. I am a little confused about it. I thought maybe you could help me.

Mr. LAMBERT. Congressman Mills, I do not want to get into the question of how much oil should be imported versus how much produced here, but I know that you asked a question regarding the justification for a depletion allowance on production in the Western Hemisphere outside of the United States. I think there is a very sound justification on two grounds: First, from the national security viewpoint, large reserves in the hands of friendly nations are very vital to our national security, and that has been demonstrated in the last two wars. The second reason is that I mentioned the national policy to encourage the venture of American capital, and this encouragement in the past has made petroleum investment the largest American export, and has encouraged building this up, and I think that is justification in itself.

We have made American capital relatively competitive with foreign capital in the development of petroleum reserves, and that is a thing that is of interest to all of us; it will help to cut down our foreign-aid load. We saw the other day that our foreign aid next year will be $3 billion. The exportation of American private capital and know-how and technical services is the best way in my opinion to cut down our foreign-aid load.

Mr. MILLS. Do you think there is justification for depletion allowance for an American company operating in Saudi Arabia for the same reason?

Mr. LAMBERT. I do.

Mr. MILLS. Any other point in the world where we should extend depletion allowance?

Mr. LAMBERT. As long as our American policy is to encourage the venture of American capital abroad, that is the most effective way to do so.

Mr. MILLS. You think the 14-point differential should be extended as well?

Mr. LAMBERT. Yes, sir.

Mr. MILLS. You are losing me. We are up to the waterline. I was trying to stay with you.

Mr. LAMBERT. I see no reason why a 14-percent differential is justified in the Western Hemisphere but not in the Eastern.

Mr. MILLS. I agree with you. I would not have it in the Western Hemisphere, frankly. Any further comment?

Mr. FERNALD. Mr. Mills, I wish I had time to speak on that subject.

Mr. MILLS. Are you for it?

Mr. FERNALD. Yes.

Mr. MILLS. You are for it?

Mr. FERNALD. Yes. I don't see why we should charge earnings made abroad which come and serve to enrich this country, the full rate we charge on all those who have the benefit of our Government services within this country.

Mr. MILLS. Mr. Fernald, is there any possibility that when you permit corporations to pay less taxes by operating overseas, or in Canada or in the Western Hemisphere somewhere, where they tell us, they already enjoy lower labor costs, that you offer them greater inducement to carry on the major part of their production and manufacture overseas?

How can you withstand that?

How is it in the interest of our own development here?

Mr. FERNALD. This gets rather long.

Mr. MILLS. I am not an isolationist. I voted for everything we wanted to give anybody until about 2 years ago. You could not call me an isolationist, but I can't see the idea of our continued practice of developing competitive forces that we can't compete with now in the oil industry or the mineral industry.

You know and I know enough about the mineral industry that we can't compete with the world in production of these minerals.

We are trying to figure out ways to prevent, or to prevent the usurpation of our markets by foreign producers.

Practically all the oil industry complains that the foreign interests will take the market here if we don't limit imports and yet the industry comes in and asks us to further complicate their situation at home by offering additional inducement for developments overseas.

Mr. FERNALD. Mr. Mills, if we need to put taxes against the importation of those undue importations, competing minerals, whether we do it by excise, or by tariff, I approve of that, but the world as a whole needs these minerals.

There is nothing that will contribute more to the upbuilding of these various countries than to make available the minerals they need.

Now it is estimated that copper production—copper requirements of the world outside of the United States in the next 20 years are going to increase twice the amount they will in the United States.

Mr. MILLS. Don't get me off the point. I do not want to get way into this thing.

Mr. FERNALD. Excuse me. I wish I had time to discuss that with you.

Mr. MILLS. I am just trying to ascertain from the panel if depletion allowances for these extractive industries can be justified here in the United States. I think it can in some form and to some amount, for various reasons.

If it can be, then, for the United States and if economic growth in the United States is promoted by providing differentials in some form, taxwise or otherwise, then what is the justification other than what Mr. Lambert has said, that we are anxious to build in these countries, what is the economic justification here at home for extending that depletion allowance to American companies engaging in production of oil and minerals or anything else overseas when we complain all the time about the importation of those things into our own markets.

Mr. NELSON. Might I make one very brief comment?

Something that has not been brought up yet today is the only reason I am saying this.

Isn't that simply one example of the tendency of this kind of thing to spread all over the map both geographically and functionally once you introduce it?

In other words, every year some one else gets a new depletion allowance.

I remember that in one set of hearings, the borax and marble industries were asking for more depletion. The reasons were exactly the opposite for each industry. There was a feeling of inequity about it everybody else is getting it and we are being left out; isn't that the problem?

Mr. FERNALD. That is no extension. Depletion was applied against foreign income ever since we started our income-tax law. Of course we only apply it if we are taking the taxes from them, and for the foreign companies, foreign subsidiaries, the United States does not give them any depletion.

How can we have American companies going in to compete as such with foreign corporations doing it?

That is just a quick question.

Mr. MILLS. Don't misunderstand me. I was suggesting that we take a consistent position.

If we insist on doing these things then let us not insist upon lack of effect here at home from that which we do.

Do you see my point?

Mr. FERNALD. I agree with Mr. Stanley that this is the question of the whole foreign trade problem, which is a different question from what we have here.

Mr. MILLS. Mr. Gray?

Mr. GRAY. I would like to make one further comment, on a matter we have not discussed this afternoon, but we have touched the edges of it, and that is this general problem of what we might call the erosion of the tax base.

Now I realize the temptation to avoid taxation at a time when the tax rate is very high and there is great pressure in this direction but I would call the attention of the committee to the fact that, as Mr. Nelson has already said, this thing spreads.

It comes as an almost irresistible form of pressure and we make the mistake I think of assuming that there is no other possible way to solve some of these particular problems that have been discussed here.

I think there are many other ways.

I think we make a mistake in assuming there is no other way, and going ahead then, steadily eroding the very foundation on which the fiscal integrity of the Federal Government depends.

I want to call attention to this paper from Mr. Helmut, printed in this volume, which is a very excellent paper and indicates that we may have gone already quite far in the eroding away of the tax base.

This is important from the point of view of the financial integrity of the Government, its ability to balance the budget, its ability to stabilize the economy and particularly its ability to do some of the things which the community demands that the Federal Government do, such as provide roads, education, etc.

Mr. SMITH. Of course this is not a new one, this depletion.

The foreign may be but what we are talking about here and have been all afternoon has been here 30 years.

Mr. NELSON. It has been spreading though.

Mr. MILLS. The foreign is not new, Dr. Smith. It applies to the depletion. It always applied across the board.

Mr. SMITH. It is 30 years old too.

Mr. MILLS. Where the American individual or corporation finds it, in other words.

Mr. LAMBERT. On your direct question of why depletion should apply to foreign countries, American capital should have the same incentive to go in foreign country as this does in the United States.

In fact, it should have a greater incentive to offset higher risks that are always present in foreign operations, and the lack of the protection of the United States, which we have here, and then we must not lose sight of the fact that the income which is produced from foreign operations comes back to the United States, and is taxed here to the shareholders, and at very heavy rates, so it is a profitable venture for the United States, and it is one reason why I assume this Government is encouraging it.

Mr. MILLS. I agree. Don't misunderstand me. I don't resist the thought at all, or attempt to argue the point, that American business should be encouraged to invest and operate wherever it can.

But I fail to understand our reasoning and the consistency of insisting that American capital be given that privilege or right and encouraged to take advantage of the opportunity to do so, then when it has done so, we completely resist and refuse to accept the product of that enterprise overseas.

Mr. LAMBERT. That relate to the imports question on which I have no comment.

Mr. MILLS. If we are not going to accept the product of the investment overseas, why are we so determined to encourage the investment in the first place?

Does somebody else have something to say?

Mr. SMITH. I think all of us can see the inconsistency of it. It seems as if you are tying a rope around the calf's neck and pulling him toward you, and using a pitchfork to keep him away.

Mr. MILLS. Exactly; a very good analogy.

Mr. NELSON. Isn't there some point in the argument that if American companies did not do it, companies of some other nationality would?

I am not trying to defend it.

I am just raising the question.

Mr. LAMBERT. Then we would recover no taxes from them.

Mr. MILLS. We would not be in position of being concerned either if we kept the product out of the United States.

You have another point.

Mr. STANLEY. I am not expert on this question, Mr. Chairman, but I have this observation, and that is that in addition to the oil that is imported into the United States a great deal of Middle Eastern oil which is produced by American companies, and I agree with Professor Nelson it is better in our hands than other countries' hands, goes to Western Europe and throughout the world, and the dollar revenue on that does come into this country. It certainly is of some help to us.

Mr. MILLS. Did you have something further?

Mr. NELSON. What worries me in that particular case is, it may prove to be better if nobody developed it at all. The Middle Eastern oil situation is very worrisome. It might be better under the sands still.

Mr. MILLS. Any further comment by a member of the panel?

Mr. LAMBERT. Certainly if United States companies hadn't developed, foreign countries would have and it might be in unfriendly hands.

Mr. MILLS. What if the unfriendly hands take what we develop anyway?

Mr. LAMBERT. They may.

Mr. MILLS. I don't want to close with this sour note.

Will somebody else say something? Senator Douglas?

Senator DOUGLAS. One comment that I should like to add, and that is a point brought up some time previously in the discussion; namely, the question of whether you should have differential treatment in depletion allowances for enterprises of different size. It always seemed to me that the case would be much stronger for differential allowance for smaller firms than for larger firms because they do not have the same distribution of risks within the enterprise, and do not have the same relative ability to charge off dry holes against successful holes; that if you have, say, 40 drillings, under the theory of probability there is a chance of getting some successes—let us say 5 successes. It would be much greater than if you have only 8 holes.

Therefore, when this question was last up before the Congress I proposed a differential rate, continuing the 27½-percent depletion allowances for concerns with gross incomes of less than $5 million a year, lowering the rate to 21¼ percent for concerns with gross incomes of five to ten million dollars a year, lowering it to 15 percent on concerns with gross incomes over $10 million a year. I thought that this would remove the objection that this reduction of the depletion allowance would be unduly severe on small firms, so it was a great blow to my faith in human nature when I found that this proposal of mine was resisted, just as much as the proposal to reduce the entire allowance from 27 to 15 percent, and I was also disappointed in that we

were not able to get 10 Senators to stand with us so that we could get even a rollcall on this matter, which I took it meant that the industry as a whole was opposed to this differential treatment.

I do think that this is a real possibility, and that it is economically justifiable, and I hope the representatives from at least the small companies, such as the Monterey Co., will see their self-interest and will join us and will not present such a solid front against those of us who try to help them.

I am looking at you, Mr. Stanley. I hope very much you will make a comment.

Mr. Stanley. I am speaking solely as an individual, but in a sense possibly as the spokesman for smaller companies.

I cannot agree with your suggestion on that. The depletion is simply recognizing a fact of nature. It is against individual properties across the board. For the larger companies I want to point out those companies are composed primarily of smaller investors and regardless of the size of the company I see no particular reason to penalize a great number of people for coming together, any more than you would penalize the people in Chicago because it is the second largest city in the country.

I want to point out that the Treasury in 1950 submitted some testimony that 80 percent of all depletion is that which is allowed to corporations. I will quote from the Secretary of the Treasury. It is in my paper on page 479.

It says:

> While the survey covers corporations only, it is estimated that corporations account for more than 80 percent and individuals for less than 20 percent of all depletion deductions.

I go on further and state:

> A substantial portion of the depletion allowed to individuals covers their royalty interests, the farm owners, and others who have leased their lands. It might be reasonably estimated, then, that more than 90 percent of depletion of operators is that allowed to corporations.

I want to point out that when earnings of these corporations are in turn distributed to their shareholders, such payments are taxed again, this time as ordinary income without recognition of the depletable nature of the underlying properties.

If we ran these depletable properties through the wringer twice without recognition of the depletion, the result would be so brutal that I just think we would go a long way toward creating terrific instability and blocking the growth of our resource industries.

Mr. Mills. If there are no further comments by members of the panel——

Mr. Lambert. May I comment on this, Senator Douglas?

I appreciate your desire to help the smaller companies, but I think it would be an unfortunate development in our tax law if it were progressive in relation to corporation taxes. There is no more reason to me for a differential depletion rate than a differential depreciation rate or operating expense allowance.

Our tax rate is progressive in one important feature, and that is the individual rate, and that may be imperfect, and possibly can be improved, but to inject progressivity into the corporation tax I think would be an unfortunate long-range development. As a matter of

fact, as Mr. Stanley pointed out, the large companies are held by millions of small stockholders. Perhaps the average investment is smaller than in the case of the smaller companies, which are sometimes family-owned and individually owned, but the large companies contribute a very important factor to our national resource development, and that is that they have the means to take the longer risks, such as the off-shore development, and in development in an uncertain area. It is a fact that in Florida, as I understand it, I think $132 million of investment was made in the last 14 years, almost all by large companies, with only $5 million of income during that period, and in the gulf coast area $275 millions was spent in exploration and development with only a return of $60 million so far, but this part was undertaken by the larger companies. I don't think they could have done it if they had been prejudiced by differential depletion allowance.

Senator DOUGLAS. I don't want to continue the discussion unduly, but I do want to emphasize that one of the justifications of the depletion allowance is to encourage exploration, and overcome the hazards of possibly finding a dry hole. As it seems to me, it seems a simple arithmetical truism that the larger the number of drillings, the smaller the risk, and that therefore the larger companies which have the larger number of drillings have the smaller amount of risk and, therefore, do not need as large an incentive, if any incentive is needed. I simply make that statement for the record. Of course, there will be a reply to that. That goes on interminably.

Mr. SMITH. Well, what Senator Douglas has reference to is the application of the insurance principal to the oil industry. For whatever this may be worth, I understand it is subject to checking and the subcommittee has the research people to check it, that the largest producer, the largest company actually in production, drilled only about 3 percent of the total wells drilled.

Mr. MILLS. Mr. Smith, are most oil wells drilled by individuals who just wildcat, trying to find oil, or are they drilled by and large, the majority of them, by operating companies?

Mr. SMITH. That was just the point I was making. I understand that.

Mr. MILLS. You said the largest number drilled was about 3 percent?

Mr. SMITH. The largest one.

Mr. MILLS. I was thinking of them altogether, the operating companies on the one hand and the individuals who have the desire to try to strike it rich. Which group drills most of the oil wells year in and year out?

Mr. SMITH. I would think that the companies do in the aggregate, but no one company drills more than 3 percent.

Mr. MILLS. Let's draw the distinction then between known fields and unknown areas.

Do companies operate in the unknown areas to a greater extent than the individuals?

Mr. SMITH. I don't think I am able to answer that. My opinion is that the long risks are taken by the wildcatter.

Mr. MILLS. That is Senator Douglas' point. I had always thought from talking to people in the oil-production business that new wells were by and large discovered by these individuals motivated with the desire to get out and find one and maybe get rich.

Mr. SMITH. I am not in the industry. These gentlemen might answer it better, but there is a great deal of dividing up of interest and sharing in it.

Mr. MILLS. Mr. Lambert is shaking his head. I assume you mean that most of the new development, new fields are found by the operating companies.

Mr. LAMBERT. I am not familiar with the statistics. The wildcatter is not always an individual. The wildcatter is a company or individual who is exploring a new well. I don't know the statistics, but I don't think they are proportionately on the side of an individual, except numerically of course, but it is a fact that the larger companies undertake the higher risk areas, such as in Canada, in the Muskeg territory, and in the offshore development of the United States.

Mr. MILLS. The ones most of my friends have invested in were not operating companies, but were established with the thought in mind that they would operate if they hit oil in that hole.

Mr. HARBERGER. I would like to comment on Mr. Lambert's side for a change.

I know the incentives that the tax laws provide are such that on the long-risk operation, that outfit which is most able to expense its costs will be in the best position, much better than somebody, just organizing a company, with just a certain amount of capital and if it is lost, it is all lost.

Standard Oil has a certain amount of capital in risky explorations. If it is lost, it is only 50 percent lost because it can be deducted against income. In this instance I think there is an a priori case, where certainly incentivewise the large companies, because of these tax privileges, will be going into this particularly risky part of the operation.

Mr. MILLS. I fear you are putting yourself over on the side of Mr. Lambert, but Mr. Lambert wouldn't be in entire accord with your statement.

Mr. NELSON. Isn't there a further question here which I might address in the form of a question to Mr. Smith? Isn't it true that very frequently you have complex financial arrangements? For any given well all sorts of people may share a part of the cost of it and in royalties. The financing is split in many different directions. You couldn't say company A did this and company B did this and Individual C did this. You might have a combination of all three, with each sharing in different proportions.

Mr. SMITH. I believe that is true, I believe Mr. Stanley is in better position to answer that.

Mr. STANLEY. You have a certain amount of sharing. One of the most basic reasons for sharing is for digging wildcat wells and you may find that 3 or 4 companies all have acreage that may be tested by a well. The most logical thing in the world is to simply go together on that. Personally I discourage too many of these complex arrangements because should you discover oil you have to live with it from then on in and you have terrific accounting problems and you turn the oil business over to the bookkeepers.

Mr. MILLS. Any further comment by a member of the panel?

Are there further questions?

Mr. LAMBERT. I would like to take this opportunity to compliment the subcommittee on the patient and good-humored way they have

heard this whole hearing and on the whole subject they are studying because they are taking a very broad view of the difficult problems of tax policy. It is greatly for the benefit of our country.

Mr. MILLS. I am sure all of us are in agreement on this point at least, that we members of the subcommittee appreciate immensely your appearance today and the information you have made available to the subcommittee, the broad character of your discussion and the many questions that you have answered which have been in our minds. We are sorry we have kept you so late. We may have caused you some inconvenience about planes or reservations of other sort. We do want to thank you for a most helpful discussion.

(Whereupon, at 5:40 p. m., the subcommittee adjourned, to reconvene at 10 a. m., December 13, 1955.)

70325—56——27

FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

TUESDAY, DECEMBER 13, 1955

Congress of the United States,
Subcommittee on Tax Policy of the
Joint Committee on the Economic Report,
Washington, D. C.

The subcommittee met at 10 a. m., Hon. Wilbur D. Mills, chairman of the subcommittee, presiding.

Present: Senators Paul H. Douglas and Barry Goldwater, and Representative Thomas B. Curtis.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. Mills. The subcommittee will come to order, please.

This morning's session of the Subcommittee on Tax Policy will be devoted to discussion of the effectiveness of tax depreciation policy in counteracting economic fluctuations and promoting economic growth.

As was announced yesterday, our procedure is to hear from the panelists in the order in which their papers appear in the compendium Federal Tax Policy for Economic Growth and Stability. At the start of each of these sessions, panelists will be given 5 minutes each to summarize their papers. We will hear from all panelists without interruption. The 5-minute rule will be adhered to.

Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session. I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee's questions.

Our first panelist this morning is Prof. E. Cary Brown of Massachusetts Institute of Technology.

Mr. Brown. Mr. Chairman, I will summarize my paper on the weaknesses of accelerated depreciation as an investment stimulus.

An examination of the 1954 provision for accelerated depreciation has led me to the conclusion that the stimulus it offers is extremely modest considering its huge and growing revenue cost. Approximately the same incentives could be provided by approximately two and one-half percentage points reduction in the corporate income tax.

Had other accelerated depreciation methods been used on a bigger scale, analysis suggests that more investment stimulus per dollar of revenue loss could have been achieved.

But, are there major economic weaknesses to the bolder use of accelerated depreciation? The most common criticism is that it would

reduce the countercyclical effectiveness of the corporate income tax. Another, that it would distort business price, wage, and dividend decisions because it would enter into a firm's accounts. Many of the benefits from its use might thus be offset.

The first criticism is based on the view that accelerated depreciation will result in depreciation deductions that move in closer conformity to the business cycle. Therefore, taxable profits would move less closely in conformity, and the automatic stabilizing effectiveness of the corporate tax would be reduced.

In my view this is not a strong objection. If we mainly face minor recessions in the future, fluctuations in depreciable asset purchases may not be large enough to result in major cyclical differences in the amount of depreciation deducted under various methods. And even if fluctuations in their purchase were large, there is no general presumption that all methods of accelerated depreciation result in a pattern of depreciation that is more cyclical than the pattern of normal depreciation. It will depend on the length of life of the depreciated asset purchased, the time pattern of their purchase, and the method of accelerated depreciation.

Belief in the cyclical effects of accelerated depreciation is also based on the view that accelerated depreciation offers a larger incentive to firms in a boom, because taxable profits are large and can absorb large depreciation deductions, than in a depression when losses prevent it. The inability of firms to absorb large depreciation deductions in a depression, however, depends on more severe drops in profit than we have encountered in the postwar period coupled with an inability to offset these losses against taxable income of two earlier and five later years under the loss carryover provisions.

More serious questions are raised by the effects of accelerated depreciation on the firm's accounts and decision making. No definitive study has yet been made of this problem. But preliminary surveys indicate that firms are tending to adopt accelerated depreciation in their own accounts. What may be a proper method to stimulate investment under a tax may not be a proper method on which to base business decisions—prices may be too high, dividends too low, and the like. Moreover, changes in the depreciation method allowed for tax purposes from time to time for stabilization purposes would be impossible without disturbing consequences on business records and decisions.

A more desirable alternative it seems to me would be a credit against tax or an extra deduction from income for investment. Since these amounts would be in addition to normal depreciation methods, they could not be adopted as depreciation in firms' accounts. Yet, they could have precisely the same incentive effects as accelerated depreciation. Moreover, they could be changed from time to time as stabilization needs required.

Economic growth could be still further stimulated by basing such a tax credit or additional depreciation on the excess of purchases of depreciable assets over normal depreciation. Static firms would thus be barred from tax relief, and the dynamic firm's tax load would be further lightened.

Mr. MILLS. Our next panelist on the calendar could not be present this morning, Mr. Joel Dean, Joel Dean Associates, Yonkers, N. Y.

Without objection, his brief summary will be inserted in the record at this point.

(The summary is as follows:)

Summary of Four Ways To Write Off Capital Expenditures—Can We Let Management Choose?

(By Joel Dean, Joel Dean Associates)

In my paper I tried to take a fresh look at the whole problem of allowing for capital wastage in income taxes. From an economic standpoint there are four main ways to allow for consumption of capital: (1) Percentage depletion, (2) the final reckoning method, (3) cash-flow depreciation, and (4) timetable depreciation. When people talk about depreciation they generally mean the timetable variety. The common arguments for or against any of these methods are generally unimportant for public policy. What is important is their economic effects, which are somtimes surprising.

Percentage depletion has several interesting economic characteristics. Perhaps the most important is that it completely solves the problem of allowing for changes in replacement cost in depreciation calculations. Because it is based on the current dollar value of the product rather than on some historical cost of the original asset, it is always tied to current price levels in a very neat and automatic fashion. In addition, it is nondiscriminatory as among assets acquired at different times or under different price levels, a feature that is certainly not present in timetable depreciation. Finally, it would be very simple to apply to all types of assets, although the results would probably lead to some unknown amount of over or underutilization of long-lived investment, just as it does in the areas where it is now applied.

Final reckoning depreciation is my term for the method we use for land and certain other types of assets. Under it no depreciation allowances are granted as long as the asset is owned, but when the land is finally disposed of there may be a capital gain or loss. This method could be applied to all assets but it is not difficult to forecast that the results would be as bad as they now are in the case of land. The operation of final reckoning depreciation on land has resulted in a trend toward land ownership by large institutional investors who lease it back to the occupants. Thus the tenant gets the right to expense his payments for the use of land, but at the cost of tying it up for long periods and sometimes in uneconomic uses.

Cash-flow depreciation has opposite effects. Under it the full deduction is taken in the year in which the investment is made. Many outlays that are really investments from an economic viewpoint are accorded this type of depreciation: installation and starting up costs on new plant or equipment, outlays for research, advertising, executive development, and other so-called intangibles. The favorable tax effects of using cash-flow depreciation offer tremendous incentive for its use. Thus businesses are led in many cases to try to earn their profits through the maximum use of expensable investments and to avoid those investments (e. g., buildings and machinery) that the Treasury requires be depreciated under the timetable system. Cash-flow depreciation could be applied to all types of business investment, and businesses would choose it if they were allowed to. Its adoption would markedly simplify tax computations and tax enforcement.

The last method is the one in most general use for the major classes of industrial assets, timetable depreciation. Although there are many variants of it, most of them are based on the assumption that depreciation deductions should recognize the way assets really wear out. This is difficult to do in any case and is generally impossible under the restrictive assumptions used in timetable depreciation. Its real effects are to give rise to continued arguments and litigation over the proper timetable and to discourage businesses from meeting the demands of the market in whichever way results in the lowest real costs, whether this way involves expenditures for long-lived assets or current materials or intangibles.

Of all the four methods I think that cash-flow depreciation is least pernicious in its effect and least burdensome in its administration. Some of its effects on the economy, if it were more widely used, would be as follows:

1. Producers would be more efficient because they would be free to adopt the best methods of meeting the market's demands.
2. Administration would be greatly simplified, releasing scarce resources for other uses.

3. Firms which had desirable opportunities to invest would be encouraged to do so by the immediate tax reduction. Firms which had no such opportunities would in effect be taxed at a higher rate. This would occur automatically and regardless of what part of the business cycle we were in.

4. Old assets would be worth only their economic value to private businesses and investors, undistorted by their value as sources of future depreciation recoveries and tax reductions.

5. Corporation income tax revenues need not be reduced by the use of cash-flow depreciation, although they would be if this depreciation method were allowed and no offsetting changes were made in the corporate tax rate. The level of corporate taxes, which is a matter for Congress to decide, need not complicate the problem of choosing the best depreciation method.

Mr. MILLS. Mr. Robert Eisner, professor of economics, Northwestern University.

Mr. Eisner, you are recognized for 5 minutes.

Mr. EISNER. Mr. Chairman, I should like to read my summary statement on changes in methods of depreciation and their effects.

The depreciation provisions of the Internal Revenue Act of 1954 are likely to have effects of the first magnitude on business tax liabilities and, consequently, on Treasury tax receipts. These effects promise to be so great as to be startling to the many who have not considered them. They may well prove of major importance to the progress of the economy.

If all taxpayers take full advantage of the newly allowable methods and the national output does not change as a consequence, we may estimate that depreciation charges over the next 25 years will exceed those that would have been allowable under the old straight-line method by more than $200 billion. The tax gain to the taxpayers affected—and the loss to the Treasury—over these 25 years would then be in the order of $100 billion.

These higher depreciation charges and consequent tax losses to the Treasury will not prove temporary phenomena. The tax losses will actually be less initially but their annual rate can be expected to increase steadily until about 1970, taper off and decline somewhat until about 1980 and then increase indefinitely, with the continued growth of the economy. The view expressed in some quarters that the initial tax loss will be recouped at a later date (aside from special assumptions about the effect of changed depreciation rates on national income) is simply mathematically incorrect. (The error is based upon a confusion between the effect of changed methods of depreciation on the charges on a single property and the effect on constant or growing streams of property additions.)

I estimate that tax losses to the Treasury ascribable to the new depreciation provisions will mount to an annual rate of $2 billion by 1957, $3 billion by 1959, $5 billion by 1964 and $6 billion before 1970. The annual tax loss will decrease somewhat in the 1970's but will still be running at a rate over $4 billion annually in 1979 and may thereafter be expected to increase.

The effects of these substantial changes in Treasury receipts will depend upon a number of things, such as what Congress does about replacing the lost tax revenues or about reducing governmental expenditures. To the extent that higher capital expenditures are encouraged at the expense of other expenditures which are discouraged by the substitute taxes or at the expense of a reduction of governmental expenditures, the new, more rapid depreciation tends to stimulate

productive capacity relative to the demand for the output of that capacity. This will appear dangerous to those whose major concern is the possibility of unemployment or depression, desirable to those concerned chiefly with inflation. The new methods of depreciation do appear likely, however, to complicate the problem of reducing cyclical fluctuations in economic activity. For, while they will reduce tax liabilities generally (except possibly at the end of a very long period of depression) relative to what they would be with the old methods, the reductions in taxes would be greatest in time of boom when they are at least desirable, and least in time of recession when they are most desirable.

In addition, in periods of depressed activity they would offer most tax relief to spenders on capital account, a group that would be least likely to spend the tax savings at that time. In regard to distributional (as opposed to aggregate) effects, the more rapid depreciation may to some extent reverse the past trend to a more "progressive" tax structure and will fairly clearly benefit much of "heavy" or capital intensive industry, possibly at the expense of commerical establishments and other segments of business whose costs relate to a much lesser degree to depreciable plant and equipment.

Mr. MILLS. Our next panelist is Mr. William A. Paton, professor of accounting, University of Michigan.

Mr. Paton, you are recognized.

Mr. PATON. Mr. Chairman and gentlemen, in the first part of my prepared statement, I have dealt with some of the commonplaces of depreciation accounting and I have tried to emphasize the fact that we perhaps sometimes exaggerate the contrast between the depreciation deduction and other deductions and also the relationship of depreciation accounting to the financing of replacements.

It seems to me perhaps worthwhile to bring out those points.

I will read my summary. The second part of my statement has to do with a special point of measurement that I have been interested in.

I. Expenditures for plant facilities, like expenditures for materials, are necessary costs of business operation and there is no basic difference between the problem of expensing plant cost and that of expensing the cost of materials and supplies. In the case of a powerplant, for example, the year's depreciation expense is the fraction or slice of the expenditures made to acquire and install the plant, reasonably assignable to the year's output. And precisely the same thing may be said with respect to the coal pile and its utilization in conjunction with the powerplant. Coal expense for the year represents the fraction of the expenditures for coal, including the pile at the beginning of the year, which is applicable to the production of the year. In both cases the deduction from revenue represents nothing more nor less than the using up of an asset—in the sense of capacity to render economic service—in the process of making and delivering a product to customers.

It is true, of course, that the capacity to render service of a boiler is commonly utilized over a substantially longer time than is the capacity to render service represented by a particular shipment of coal, but this fact does not warrant the conclusion that the two types of cost are basically different.

In some quarters the impression seems to prevail that the process of charging plant cost to revenue, in the determination of net income, automatically provides funds and that all that is necessary to obtain more money for replacement or expansion is to accrue more depreciation. There is little or no justification for this view (except insofar as taxable income might be affected by a change in depreciation procedure.) Funds are provided by collections from customers and for most business concerns particular accounting procedures and cost computations have only a very roundabout and minor influence—if any—on the price of the product. Certainly the typical enterprise is in no position to bill customers for costs as specifically calculated, regardless of market prices; producers do not in general operate under the protection of cost-plus contracts. And the same is true of other types of charges, such as the cost of materials; with respect to no type of cost incurred is there any specific assurance—in most cases—of recovery from customers of the amount expended.

Recognition of depreciation expense, moreover, has no direct relation to what becomes of the money received from customers. Available funds are used to pay current accounts, including taxes, to pay interest, to reduce long-term debt or redeem preferred shares, to expand inventories, to acquire additional plant facilities or other noncurrent resources, to pay dividends, to build up cash backlog. In this overall process, varying with changing conditions and managerial attitudes, it is seldom if ever that the amount of depreciation accrued during the year is a decisive factor in molding decisions as to particular or total plant expenditures, and seldom if ever does the increase in cash backlog approximate the amount of the current depreciation charge.

It follows that the connection between periodic depreciation accounting and the timing and financing of either replacement or additions is by no means as close as is often assumed. Intrinsically, the purpose of charging plant cost to revenue as plant capacity is consumed, together with other costs of operation, is the correct measurement of net earnings (or loss). And this purpose remains dominant, and the pattern of sound expense accounting unchanged, even where there is no intention of replacing the property being consumed (in the case, for example, of a mine shaft with a physical life greater than the period required to exhaust the ore body).

II. In recent years, in my judgment, accountants and others interested have been unduly concerned with the question of how to spread the cost of plant installations over estimated service life, to the neglect of a much more important problem: the correct measurement of the cost of plant capacity consumed in the light of the market change in the monetary unit, the accountants' yardstick.

As we all know, the value of the United States dollar has been cut in half during the past 12 to 15 years, and this fact has posed a serious difficulty in the field of financial measurement generally and especially in the use and interpretation of the raw data of the accounting process. This problem has been widely discussed, and the nature of the difficulty and the need for amendment of conventional procedure clearly pointed out by leading professional accountants and others, but thus far in this country—unfortunately—there has been no systematic adoption of corrective measures.

This state of affairs is somewhat amazing. Laymen as well as statisticians are well aware of the fact that unlike units in any field of measurement cannot be combined without a process of conversion. Thus, no one would for a moment consider adding meters and yards, long tons and short tons, without reduction to a common denominator. And in the field of finance no one would think of adding pounds sterling and United States dollars, or even Canadian and United States dollars (seldom far apart in value) without a meticulous conversion to a single base unit of measure. But we have been adding, averaging, and arraying prewar and postwar United States dollars, which are similar in name only, and generally without even calling attention to the resulting distortions of earnings and other accounting data.

The connection in which this error is most serious is that of accounting for cost of plant capacity consumed. This results from the fact that plant is an asset with a relatively low rate of turnover; a particular installation commonly renders service for a considerable period, and thus the change in the value of the measuring unit—the dollar—may be substantial during the service life of an installation.

I submit that cost is not merely a number on a piece of paper; if the term has substantive meaning it refers to the purchasing power expended, the economic sacrifice made by the person incurring the cost. It follows that a 1955 dollar received from a customer does not represent full recovery of a 1940 dollar—for example—of plant expenditure. When we make such a comparison, without conversion to uniform dollars, we are not correctly reporting the actual cost of plant capacity consumed and thus are misrepresenting the results of operation.

This brings me to my main point. In our present tax structure the owners of depreciable assets are often placed at a serious disadvantage as compared to investors in inventories of materials and merchandise. Inventories, in the nature of the case, are seldom held more than a year or so, and hence the cost of goods consumed is usually expressed in dollars not substantially different from the dollars represented in the cost of goods purchased. Moreover, through the use of the LIFO procedure authorized by Congress some years ago, the process of matching revenues with current costs is facilitated.

The inequity is especially glaring where a major part of the taxpayer's plant capacity was acquired in prewar years. Thus, the owner of a building acquired in 1940 with cost recorded in 1940 dollars is required by the present tax structure to treat one 1955 dollar of revenue as the full equivalent of one 1940 dollar of investment absorbed. He is assumed to be breaking even when he is recovering only 50 percent of the actual cost incurred. Taxpayers in this situation, notably in public-utility fields, are actually being taxed at substantially higher rates than taxpayers with investments primarily in inventories or in plant capacity acquired in the postwar period.

In taking note of the large amount of construction and additions to equipment in recent years, we are likely to lose sight of the fact that a very substantial part of the total plant capacity of the country was acquired 10 years or more ago, and that the correct measurement of the periodic consumption of this older plant capacity remains an important problem. If we are interested in encouraging replace-

ment, modernization, and expansion in this area we are certainly not going about it sensibly when we deny taxpayers the right to deduct actual cost incurred, measured in current dollars, in determining taxable earnings. Granting the right to use some form of decreasing-charge procedure (accelerated depreciation) in computing depreciation on new plant isn't much help to the owner of prewar plant who is permitted to retain from revenues, not subject to tax, only half of the purchasing power actually invested, and generally much less than half of the money required to replace the plant capacity consumed.

There is badly needed, to correct this situation, some form of LIFO procedure, or a conversion technique such as is employed in some foreign countries, applicable to the older installations of plant.

Mr. MILLS. Our next panelist this morning is Mr. George Terborgh, research director, Machinery and Allied Products Institute.

Mr. Terborgh, you are recognized.

Mr. TERBORGH. The importance of depreciation allowances from the standpoint of public policy stems primarily from their role in the financing of productive capital formation. Even on their present inadequate basis, these allowances—or, more accurately, the funds they make available when earned—account for more than half of the fixed capital expenditures of American industry. On an adequate, that is to say, a realistic, basis, they would cover a considerably higher fraction, notwithstanding the increase in expenditures that would undoubtedly accompany larger allowances. Depreciation is normally the major source of business investment funds.

This fact should make sufficiently obvious the desirability of realistic depreciation allowances. For it stands to reason that the reporting of capital recoveries as income—the inevitable result of underdepreciation—is bound to affect adversely the supply of capital funds. This would be true even if the erroneously reported income were free of taxation, but it is doubly so under the impact of the high tax rates now prevailing.

The reason for this adverse effect is easily stated. From the standpoint of its availability for capital investment, a dollar reported as taxable business income is subject to a twofold or double erosion. It is reduced both by the applicable income taxes (corporate and personal in the case of an incorporated business, personal in the case of a proprietorship), and by any consumption expenditures made by the owners from dividends or proprietary withdrawals. With the present tax structure, this double erosion ordinarily leaves for investment only a minor fraction of the original dollar. When the dollar is reported as depreciation, on the other hand, it usually remains intact. As a capital recovery, it is tax free. Moreover, because it is a recovery and not income, it is normally regarded by management as unavailable for distribution, hence is protected against consumption by the owners. Both forms of erosion are thus avoided. From the standpoint of capital formation, a dollar of depreciation is worth several dollars of taxable income.

There has been a growing realization in recent years of the importance of depreciation as a source of capital funds, and the trend is definitely toward its liberalization. Since World War II, a number of countries have increased their tax allowances in one way or another,

and these increases have generally been reflected, voluntarily or by requirement, in enlarged depreciation for accounting and managerial purposes.

The United States joined this movement in the Revenue Act of 1954, by authorizing the use of the double-rate declining-balance and sum-of-the-years'-digits methods (on assets acquired new after 1953). This step promises a gradual improvement of our tax depreciation and eventually a better comparison with other countries.

It is a matter of common observation that the services of capital assets tend to be less and less valuable as time goes on. There is, of course, no mystery about this phenomenon. The majority of such assets require during their service lives a flow of maintenance expenditures, which as a rule rises irregularly with age and use. Most of them suffer a progressive deterioration in the quality or the adequacy of their service. Moreover, in a dynamic technology such as ours they are subject to the competition of improved substitutes, so that the quality of their services declines relative to the available alternatives even when it does not deteriorate absolutely. All of these factors—rising operating costs, impaired service quality or adequacy, and improved alternatives—combine to reduce the value of the service as the assets age.

Because the most valuable services of a progressive asset are used up first, the decline in asset value normally is accelerated, in the sense that it is more rapid in the early part of the service life than later. Granted that the depreciation method should reflect this general pattern, the question remains how much acceleration is warranted. Do the new methods of the 1954 code, which write off roughly two-thirds and three-quarters of cost over the first half of the estimated service life (by declining-balance and sum-of-digits respectively) go beyond a reasonable degree of acceleration?

Our investigation of this question points definitely to the conclusion that for capital equipment at least the new code methods are soundly realistic. When we remember that equipment accounts for the overwhelming bulk (about five-sixths) of business depreciation charges, it will be apparent that any element of "incentive" inherent in these methods is relatively negligible. By and large, they are about as close to realism as we can get in any procedure designed for across-the-board application.

The new methods constitute a notable advance toward adequate tax allowances. In our judgment they should be continued on a permanent basis. In addition, further consideration should be given to adjustment of depreciation for the effects of inflation, giving careful study to the experience of other countries. Finally, this committee, if it wishes to appraise the true impact of the new depreciation law, should at an appropriate time give consideration to the regulations of the Internal Revenue Service when finally issued.

It should be emphasized that the allowance for tax purposes of realistic depreciation deductions is not a handout or giveaway to business, big or little. On the contrary, it is no more than business can properly claim and no more than it properly deserves. To allow less is to enforce a distorted reckoning of taxable income, resulting in the taxation as income of what are really capital recoveries. We have already noted that the effect of such taxation is an erosion of

the funds available for financing productive capital formation, and an impairment of the vigor of the economy.

It is a grave mistake to regard tax depreciation as a matter in which the average citizen has no interest. This would be true only if he were unconcerned with economic progress and the improvement of his standard of living. But since he is concerned with these things, he has an interest in a broadgaged intelligent depreciation policy.

That this is a truth more vividly appreciated abroad than in this country is one of the curiosities of the modern world. Surely it is an anomaly that prior to 1954 the United States, which regards itself as the exemplar of the private-enterprise economy, should have lagged in this area of policy so far beyond even Socialist governments in other lands. Now that it is started on reform, it should persevere lest it again enjoy the dubious distinction of treating private business in this respect less favorably than do its professed enemies.

Mr. MILLS. We thank each and every one of you for the splendid summaries of your presentations appearing in the compendium.

As I have said during the course of each of these panel sessions, the principal purpose of these hearings is to bring into sharp focus basic economic principles for the purpose of evaluating our present tax system, and to formulate broad guides or principles to a tax policy for economic growth and stability.

The question of the proper tax treatment of depreciation is of major importance in such a policy. In the discussion of tax issues during the past hearings, it has been brought to light that there are three major questions which are raised in considering any aspect of the present tax system or tax policy that we may propose:

Does it contribute to the built-in stabilizing capacity of the tax system? Does it promote efficient allocation and use of resources? Does it enhance or weaken the position of small and new businesses in the economy?

I wonder if we might approach the subject this morning in the light of these three criteria or questions.

Mr. Brown, would you lead off? Do you have in mind the three?

Mr. BROWN. Yes.

Well, take the first case, the effect of increased depreciation charges on built-in stability of the system. I wouldn't say that accelerated depreciation would improve the built-in stabilizing effectiveness of the corporate income tax, but I did want to put a questionmark beside the general view that people leap to, that it reduces the built-in flexibility of the corporate income tax, because this is a very, very complicated result, depending upon a number of things that I have indicated in my paper. So all I could say here is that I can't see this improving built-in flexibility. On the other hand, I doubt that it is going to reduce it very much unless we think in terms of really catastrophic depression like the thirties.

Mr. MILLS. Pardon the interruption, Mr. Brown. You are not saying that depreciation in some form should not be a part of tax policy for the future?

Mr. BROWN. No.

Mr. MILLS. You question that if it is continued as a part of tax policy, that it gives any built-in stabilizing capacity to the tax system?

Mr. BROWN. I should distinguish between accelerated depreciation and what we would call normal depreciation, let's say to properly

measure income. That is debatable. I think Mr. Terborgh, for example, would say existing methods properly measure income, and some of the rest of us might say this is less clear. But whatever depreciation method you think properly measures income, that should be continued under an income tax. The thing I was addressing my remarks to was accelerated depreciation. That is, something over and above what anybody would regard as normal depreciation. I don't see that as increasing the stabilizing effectiveness of the tax, but on the other hand, I don't see that it will be a serious destabilizer, either; that is, I don't think this is decisive in this particular case.

Mr. MILLS. Actually, then, it should not be judged in the light of its stabilizing or destabilizing effect?

Mr. BROWN. That would be my view; that this is not important.

In the allocation of resources, this is a more complicated question. I think that, generally speaking, some method of accelerated depreciation could improve the allocation of resources; that is, could reduce the disincentive effects of the corporate income tax, but it would have to be a more drastic method than the present one. It would, in my view, also have to be one that was independent of the length of life of the asset, because I would want firms to make their business decisions, not on the question of the amount of depreciation they would be allowed for tax purposes over the life of the asset, but rather to realize that whatever asset they purchase, be it a 5-year, 10-year, or 50-year asset, it would have just about the same tax implications for them.

The last point on the effects of accelerated depreciation on the position of small versus new business—small versus large business——

Mr. MILLS. No, just whether it weakens the position of small or new business or enhances it.

Mr. BROWN. I think, generally speaking, with long loss offsets, as we now have them, that drastic accelerated depreciation is a method whereby small and new firms can postpone taxes. Since we know these firms, generally, are firms with inadequate capital sources relative to large business, it should improve their position in the economic structure, but again I should urge that I think of this as a more drastic program than we have yet initiated.

Mr. MILLS. What do you mean by "drastic accelerated depreciation"? Do you refer to what we commonly call "rapid amortization," or do you refer to the new provisions of section 167?

Mr. BROWN. No; I am thinking of 5-year amortization, 10-year amortization, of sharply accelerated methods. However, I prefer actually, basing this additional deduction, not on 5-year amortization or 10-year amortization, but I prefer this method, of which I have mentioned, to stimulate growth, whereby you allow the firm an extra deduction, based on the relationship of the outlays it is now making to what we choose to call realistic or normal depreciation. That would then give it an additional incentive for growth. This would be especially important for the new and the small business.

Mr. MILLS. Let's forego, for the moment, a discussion of what I refer to as rapid amortization, which I think we all agree is utilized in times of some emergency, or otherwise, when we think the circumstances justify the attainment of a goal, and we use tax stimulants to get certain industries or certain groups to assist in the attainment of that goal. Let's forego a discussion of that for the moment, and let's

apply these three criteria to what we refer to as depreciation as outlined in section 167 of the code.

Does that type of depreciation contribute to built-in stabilizing capacity; does that promote efficient allocation and use of resources; does that enhance or weaken the position of small or new businesses?

Mr. Brown. Well, I would say, again, that it is a very modest effect that we observe under section 167, and nothing like the more drastic things of which I have talked.

I would think that in each of these cases, the results would be approximately the same as I have stated, but much more subdued, less observable, and in the case of the small and new business firm, it seems to me, from the analysis I have made, that the risky enterprise is really favored no more under the section 167 depreciation than would be across-the-board rate reduction of about 2.5 percentage points.

As near as I can see, we would get the same relative effects. Now if you say does tax reduction help the small business firm, to some extent it does, yes. But if I am cutting out the extra depreciation deduction and inserting a 2½ percentage point rate reduction, say, then I think my conclusion would be that these would be about equivalent, as far as the small new firm is concerned.

Mr. Mills. Mr. Eisner, will you comment on the proposition?

Mr. Eisner. It seems easiest to me to comment in terms of the changes that the rapid depreciation means, as compared to the preexisting situation, and that involves some difficulty, because we must make some kind of a political judgment as to just what all of the changes are likely to be. It seems clear to me that the rapid depreciation will, in itself, result over the years in a substantial loss of tax revenues to the Treasury.

Now in order to predict what the effects will be on each of the questions raised, we have to have some notion as to what Congress will do about making up the losses in tax revenues, or what it will do about reducing expenditures.

With that in mind all along, I would suggest that as far as stabilization goes, and any effect rapid depreciation may have, I don't know that I depart too far from Mr. Brown in terms of the magnitude of the effect. But, I think what effect it would have would be to complicate the problem of stabilization, in that while the rapid depreciation will reduce tax liabilities at all times, under some fairly reasonable assumptions, with a major depression it would, I think, probably reduce tax liabilities somewhat less than it would in a time of boom.

This, I will agree and concede to Mr. Brown, does depend upon the exact assumptions you make about the regularity of the cycle and the length of life of the properties, and also of the exact nature of the rapid depreciation.

I do have in mind implicitly the methods in section 167.

There is, I think, a somewhat more important effect upon the stabilization problem than the relative magnitude of the tax reductions, and that is that these tax reductions will go to businesses primarily who make capital expenditures. Now, in time of depression, it seems to me these businesses would not be likely to use their tax reductions to swell demand, because we find the capital expenditures are very cyclically sensitive in a time of substantial downturn in economic activity.

Business would not use such tax saving to increase expenditures in a period of depression. Therefore, in terms of the other changes that

might occur, if compensating taxes were raised somewhere else, let's say on consumers, it would seem that on the one hand, in a depression, you would have a reduction in taxes to business who were not taking advantage of the reduction to increase demand, but you would have on the other hand an increase in taxes to consumers, which would effectively reduce consumer demand in that period, as against a situation where you would not have rapid tax depreciation on the compensating relatively higher other taxes. So along these lines I think what evidence there is suggests that the rapid tax depreciation will complicate the stabilization problem.

On the growth issue, again, I think you have a serious problem of just what the other changes that would be introduced to compensate for rapid tax depreciation might be.

If you can abstract from the problem of different effects upon demand by changing distribution of income after taxes, you would find that the rapid depreciation does encourage capital expenditures at the expense of some other kind of expenditures. This would mean since capital expenditures clearly generally increase productive capacity, there would be some increase in productive capacity, and as I have suggested in my paper, if we have a problem of demand for that capacity, then we run into the rather curious paradox; on the one hand, we are doing things we all would like to do, increasing capacity to produce goods; on the other hand, we may be creating a problem of a demand for the output of this capacity.

If we foresee no problem in demand, either because of our confidence in the ability of the economy to adjust or because of our view of what Government expenditures and action will be, then we might argue that we should increase capacity to the utmost and perhaps in that way promote actual growth. I might suggest that, of course, capital expenditures are not only way to increase capacity, and this kind of change is a changed kind of intervention by the Government, which means that capital expenditures will now be relatively more encouraged than other things that might expand capacity, such as research, education of workers, or anything of that kind, the tax advantages of which are not changed by the law.

Finally I might suggest on the small and new firms issue, which has been raised, that this would seem to be a rather shotgun effect, and rapid depreciation will do a lot of things in the way of reducing tax liabilities for a lot of firms.

Incidentally, it may help some small and new firms, but it is not particularly likely to help the small firms as against the large ones, and I think it may help the new firms as against the older firms less than one may think because my impression is that new firms are probably not making high profits initially anyway.

They go through a period of proving themselves and getting established, and in this period, then, when the rapid maximum depreciation could conceivably be of greatest advantage because they are making heavy capital expenditures, they don't have the profits to give them the great tax savings. Of course, if there is an adequate carry-forward on losses, they may be able to recoup later, but they still will not gain from the general interest saving of getting the tax depreciation at an earlier period.

Mr. Mills. Mr. Paton, would you comment on the proposition?

Mr. PATON. Mr. Chairman, I am not sure that what I have to say bears very pointedly on some of the considerations you raise but I will request your indulgence to make a few comments in any event that perhaps do have a little bearing.

Mr. MILLS. Pardon my interruption. If I may, let me direct this question to you preliminary to your discussion of the three.

Should our consideration of depreciation as a part of tax policy for economic growth and stability be concerned with an evaluation of depreciation in these three lights?

Mr. PATON. Yes. I think that it is legitimate, sir, to consider these matters, because whatever our conception of the tax system may be, we must all realize that it is related, especially in the light of the scale under which we are operating now, to very fundamental economic questions. Even if you believe in taxes for revenue only, the fact remains that these questions are in the background, and therefore I think it legitimate to consider them.

Perhaps what I have to say has a little bearing.

In my own conception of the tax structure, the Federal income-tax structure, particularly thinking of corporations, but with some relationship to the unincorporated field also, I have always been very much concerned with the general problem of equity between groups of taxpayers.

I think it is certainly not stabilizing, and it is not, generally speaking, conducive to general growth, to have glaring inequities. I appreciate the fact that sometimes perhaps more equity can be achieved with a meat ax than with a scalpel; I have too often thought we have put too many fussy features into our tax structure, trying to preserve equity.

Many of the complications of the structure arise out of the desire to try to keep things on an even keel, keep relationships equitable, but I still think that is an important question.

I also believe that the correct, or let us say reasonable, measurement of periodic income is a vital consideration in preserving equity and in creating stability, if you please, and in creating a foundation for growth. And it seems to me that the thought should be constantly in the minds of those who are building our tax structure or amending our tax structure that for a taxpayer, corporate entity or otherwise, a sufficient part of the revenues should be considered free of tax to at least permit the replacement of the capacity that is used up in creating the product of a given year—either raw materials or plant capacity or anything else. There are lots of problems, and there is room for argument about particular computations, but that it seems to me should be a cardinal principle.

There should be a flow, assuming the business successful enough to get the revenues, there should be a flow of revenue funds tax free sufficient to replace the actual cost of using up the various resources, current and otherwise.

I think that permitting such a flow has a very important relationship to these questions which you listed, particularly in connection with the formation of capital, which seems to me of enormous importance to us.

I agree with Professor Eisner that it is not just a question of capital goods as such. It is capital goods plus savvy—the know-how—but I am not sure those two phases of the problem are separable.

I have been one of those who has been worrying and fretting about the formation of capital in this country in recent years, especially what I call venture capital. I don't see how you can have a private-enterprise system without a healthy layer of risk money. The alternative to that is the tax power of some governmental entity. I have been alarmed at what seems to me the meager flow of venture money to business. We are all borrowing, or issuing, preferred stocks, which is another form of borrowing, really. In spite of the advance in the stock market the fact remains—a fact that can be demonstrated—that the flow of new venture money has been very considerably dried up in view of the size of our economy.

Therefore it becomes very important that we at least encourage internal formation of capital.

Certainly full replacement of the capacity consumed is vital, and unless a businessman or anybody with funds feels that that is assured he is not going to be very encouraged in the direction of retaining net earnings, so-called, or in putting in additional funds from the outside. Thus a sine qua non of capital formation is the permitting of deductions year by year that at least is free from tax, the portion of revenue sufficient to cover all the capacity utilized, used up in the year, including a reasonable estimate of plant capacity. This consideration underlies equitable and fair determination of taxable income year by year, and it underlies, as I see it, the questions of both stability and growth.

Prompt replacement—willingness and ability to throw out the quasi-obsolete methods and put in new—is extremely important. And you can't get that in my opinion adequately under a tax system that is not fairly liberal in the matter of deductions.

I would like to say a word on this specific feature of the 1954 code that has had a lot of discussion. I tended to minimize it in my paper, because some of my colleagues in this group were covering it.

I want to make it clear that I am not opposed to permitting more rapid writeoff in the early years, if that seems to fit in with the taxpayer's conception and picture.

This is particularly desirable in the case of highly specialized equipment. I think even this emergency amortization (which we had back in World War I for that matter, and have had since on a larger scale) is in some sense realistic in that when you build specialized facilities to carry on an emergency activity like production of some specialized war goods, there is a great uncertainty with respect to the economic life of those particular facilities.

The greater the uncertainty the more reasonable it is to permit relatively large deductions in the early years, so I would be inclined to argue for the realism in equitable and fair income determination for many situations of this depreciation—type of depreciation—that is now recognized in a rather definite way in the 1954 code.

It is true, as Professor Eisner says, that for some new companies it might not be of any great advantage. Where you have losses in the early years of operation there is no special advantage in having somewhat larger depreciation deductions in those earlier years. Nevertheless, I believe that there are many businesses, and many types of

equipment, where you can very well say that a decreasing charge procedure, that is, relatively heavy charges in the early years and a tapering off in the later years, is actually good income determination and hence fits right in with my conception of a structure which gives the taxpayer a feeling of confidence with respect to the administration of his revenue funds.

He will have revenue funds available to replace not only the coal pile, as I say in my full piece, but the boiler.

Mr. MILLS. Mr. Paton, the type of depreciation to which I referred earlier as rapid amortization was not developed and utilized as a device for determining income, was it?

Mr. PATON. I think not primarily. It was an incentive. It was designed to attract private capital into the support of the war effort.

Mr. MILLS. We had 1 of 2 approaches: either to use public moneys, or to encourage private funds to accomplish the goal.

Mr. PATON. I agree heartily.

Mr. MILLS. We were not thinking of rapid amortization in terms of measuring income in the years of its application.

Mr. PATON. Not primarily, sir, although I would like to throw out this thought, that frequently with respect to such types of investment there is a considerable uncertainty as to the economic life so that what might be called liberality is not utterly out of line with the measurement of income.

I agree wtih you, anyone who traces through the hearings will realize that the amortization of emergency facilities was a sort of tax subsidy in a way.

Mr. MILLS. It was a device to get private money to do what private money would not otherwise have done and public funds would have had to do.

Mr. PATON. Unquestionably.

Mr. MILLS. Section 167, however, is a device, among others, to try to determine what income within a given year may be.

Mr. PATON. That is right.

Mr. MILLS In that section we say that there shall be allowed, as a depreciation deduction against the gross income of a concern, a reasonable allowance for the exhaustion, wear, and tear of property used in the trade or business, or of property held for the production of income.

Now we allow that deduction because under existing law we feel that without the deduction, we would not reach a true determination of income.

Is that your opinion?

Mr. PATON. That is correct.

Mr. MILLS. Then in 167 (b), we undertake to set forth different accounting methods for determining this deduction; do we not?

Mr. PATON. Yes, sir.

Mr. MILLS. Would you take the time, for the benefit of the record, to advise us briefly what is meant by the straight-line method, the declining-balance method, the sum-of-the-years'-digits method?

Mr. PATON. I would be glad to.

Mr. MILLS. You are a professor of accounting and this is an accounting matter.

Mr. PATON. The overriding problem in the technical determination of depreciation of course is service life—how long will a facility be used, and if there is a difficulty in depreciation accounting as compared to coal-pile accounting, it is the greater uncertainty of the length of service life.

None of us are prophets and none of us know when a building or other structure or a power tool is installed what the retirement date will be.

We just don't know. So our first estimate—and I think it is the basic estimate in any depreciation accounting—is service life. I think that is the real underlying difficulty.

If I knew some way to advise my students or anybody else accurately in that area, I think I would feel I was quite a wheel and could contribute something to good business management and equitable taxation.

We know something about it. We have a lot of data that have been compiled on the matter but we do not know.

I personally do not think the mortality tables from the insurance field can ever be applied to this particular problem with any great degree of success. It is a matter of judgment, in other words.

Now, there is the first question, service life, and the first question for the tax administration on that point is how much leeway are you going to give to the taxpayer in the determination of service life?

I think that through the years the Bureau of Internal Revenue, the Internal Revenue Service, has generally been fairly liberal in that determination—how long will the stuff last? I don't think that the Government has been niggardly. I think we have fought the taxpayer frequently when we might better have said, "You go to it in your own way, and we will get you in the end if you write it off too fast, and if the rates are higher in the later years you are going to be in a bad way."

That is the first question.

Mr. MILLS. Pardon the interruption at this point, Mr. Paton.

Are you saying now that bulletin F is fair, in your opinion to taxpayers?

Mr. PATON. I think in general it has been. I do not think anybody can argue that we have been niggardly in the estimating of service life.

We have taken into account backhandedly or otherwise the possibilities of obsolescence and all that, and we have not gone ahead in an unrealistic way in general on this question of service life.

Now the second question is, having determined the service life, how should you schedule the base amount through that period, and that is the question that has received so much attention in the last year or two.

As I indicate in my piece, I feel maybe we have given it more attention than it deserves but it has received a good deal of attention. That is the thing that is written up in the text books, always has been.

I think I know something about it, and I must say that I am pretty much of a straight liner.

What I mean by that is that I think that the straightline procedure—the spreading of the basic figure uniformly over service life—has considerable merit, although there are of course some objections. It is simple, and with a reasonably conservative service life estimate—not

too long—straight-line depreciation to my way of thinking takes care of many cases quite well.

On the other hand, I have always felt, and still feel, that there are a lot of situations where different scheduling may be appropriate, and I do not believe that the Government ought to prohibit different methods of scheduling—how far we want to go to promote different methods of scheduling is a question. I would say that our internal-revenue man would sit down with the taxpayer occasionally and find out what his plan is and if it is within the bounds of reasonableness, O. K.

Now the more specialized the property is the more justification there is for the view that it loses its ability to function rather rapidly in the early years, so I am sympathetic with allowing a range of possibilities to the taxpayer, after we have settled on service life, allowing him a range of possibilities with respect to how to schedule the depreciation.

Your main possibilities are three: the straight line, or uniform deduction.

Mr. MILLS. That means that if it is determined by the taxpayer and the Bureau that this particular item has a useful life of 20 years to the taxpayer——

Mr. PATON. Yes.

Mr. MILLS. Then you may deduct in each year——

Mr. PATON. A twentieth?

Mr. MILLS. A twentieth.

Mr. PATON. Of whatever the base figure is. Very frequently salvage is assumed to be effset by abandonment costs and we rough it in that way.

I also believe in not fighting the taxpayer too much on the matter of service life. If management has a sincere view with some data to back it up I think we ought to allow considerable weight to that, and in my opinion the Service generally has.

A second possibility is the old-fashioned so-called sinking fund or interest procedure—it has a lot of variation but is really a simple thing, resulting in an increasing charge, skimpy in the early years and heavy in later years.

For fairly obvious reasons American businessmen have never liked that. They feel that that does not conform to reality in view of the risks involved.

Mr. MILLS. Furthermore, does it actually reflect the depreciation?

Mr. PATON. I doubt if it does.

Mr. MILLS. At the time it most depreciates.

Mr. PATON. I doubt if it does. It can be argued for under certain rigid assumptions. For instance, if you have a piece of property, like a leasehold, which has a fixed and agreed upon income to start with so it is just like an investment, you can argue for that kind of a scheduling. Thus we have really got just three possibilities, that is all there are—the flat or uniform charge, the increasing, and the decreasing.

Now I think they should all be allowed.

Mr. MILLS. At the election of the taxpayer?

Mr. PATON. Yes, subject to—I say at the election of the taxpayer, but I believe in riding herd on him to a certain extent.

That is, there should be conferences, and so forth, so to see that the thing is not capricious, is not arbitrary.

All we are doing in modifying the code is permitting, authorizing, a scheme that has been orthodox for a long time. The particular methods we have selected are twice the straight-line rate applied to the net balance and the sum of the years' digits method which is kind of an arithmetical curiosity, but it does give you a scheduling which I think is just as realistic as any other plan for a lot of our equipment.

If I had anything to do with the management of a business concern I would try to adopt it only where I thought it had genuine application in the measurement of income, because I still stick to that as the underlying point.

Now I personally think, Chairman Mills, we have made a little too much fuss about this question at times.

The determination of service life is a difficult question and I think the Bureau and later on the Internal Revenue Service has generally been liberal.

Now we are showing a little more liberality with respect to methods of prorating. That is all we are showing. There is nothing that is not orthodox or has not been orthodox some place for 75 years in the code on these matters, so while I am no enthusiast about pushing for the general adoption of the heavy depreciation in the early years, tapering off in the later years, I think that it does encourage business activity and creates a feeling of confidence where you have risky assets, where you have very speculative assets, for example a tool that is nothing but a mass of junk if not used for some specialized purpose.

Those are assets with respect to which that device actually makes sense, and I do not see any reason under Heaven why we should not allow it.

Maybe we should not just allow it everywhere. That could be argued.

On the other hand, I am not in favor of spending too much time and money arguing with taxpayers when you get into the general area of reasonableness.

Mr. Mills. Mr. Paton, which of these methods was added to the code in 1954?

Mr. Paton. The sum of the year's digit method was specifically added and as I understand it, the doubling of the straight line depreciation applied to the net balance

It wasn't my understanding that prior to 1954 that that was a general scheme. The Treasury I think, by regulations, and so forth, had tinkered with it, allowing one and a half times the straight line rate applied to the declining balance, but as far as I know, doubling the straight line rate applied to the declining balance was officially recognized in 1954.

Mr. Mills. It had been a suggestion of the Treasury to the Congress in earlier years, that we apply 150 percent to the straight-line method, but only in connection with the code of 1954 was the suggestion raised to 200 percent. Is that correct?

Mr. Paton. That is correct, and one reason that it has been raised in my humble opinion is that 150 percent—or one and a half times—is no good if you check it out arithmetically.

Mr. Mills. Doesn't the problem, other than the accounting problem, of the equity and the fairness of your accounting methods for depreciation actually arise not so much in the method utilized in tak-

ing within given years that depreciation percentage which is determined by the number of years which is deemed to constitute the life of the piece of property, but in the application of old 117 (j) to the residue, and also in connection with the question of the useful life in the beginning of the property to which these various computing or accounting methods are applicable—if you understand what I mean.

Mr. PATON. I think so.

Mr. MILLS. On your salvage question, what is the nature of the income to be derived from the sale of a depreciated item?

Mr. PATON. I don't believe—I would be inclined to say that the salvage question is not an important aspect of it.

Mr. MILLS. It has been to the Treasury for some time, and to the Congress. I know right at the present time the Treasury is having difficulty with regulations about the question of salvage under this new section.

Mr. PATON. In cases—aside from any new section, the question of salvage of course, is a part of the calculation, or may be. Now, my observation is—such information as I have would lead me to the conclusion that the Treasury Department, the Internal Revenue Service, has generally speaking been willing to set up a service life that was reasonable, as I said before, and to permit the taxpayer to assume that there wouldn't be any net salvage. In other words, permit him to assume the demolition cost would about offset the proceeds from the property and, if that turns out not to be the case, we have the question of capital gain; that is, a gain on the disposition of the property, and it is not my understanding that that is tax free or anything of the kind under our present setup.

In other words——

Mr. MILLS. The point about it is this: That the losses are ordinary losses, and the gains are capital gains.

Mr. PATON. Yes.

Mr. MILLS. That disturbs me, and then the fact that we apply the various accounting methods in section 167 to property with 3 years' or more useful life disturbs me.

I find no particular difficulty in going along with the various accounting methods in depreciation, as you point out you don't, but I do have some difficulty in applying all of the various accounting methods set forth in the section to property of a short, useful life, for example, 3 years.

You didn't see it because I don't think it appeared anywhere but in a Washington paper a few months ago. One of our writers here in Washington, I think for the News, Mr. Othman, pointed out what would happen in the case of automobiles under section 167, where the declining balance method, or the sum of years digits method, could be used for accounting purposes in determining depreciation. The Cadillac automobile, for example, could actually be used for 1 year and at the end of the period, by virtue of the capital-gains-tax rate applied to the net proceeds from the sale of the automobile, the original purchaser of the Cadillac would end up with a profit for having used a Cadillac in preference, say, to a Ford, which might not have as long a useful life, or might not have as proportionally great a value in resale as a Cadillac.

In other words, we must always be careful, I think, in the application of depreciation, to see that we do not depreciate for tax purposes

at a more rapid rate than the item or article is depreciated on the market, shouldn't we?

Mr. PATON. In general, yes. Of course, you have got a special situation in motorcars in that you do have these blue books and figures that you can get hold of on cash-market value.

For a great deal of property in business there is no such market and, in fact, in general, the value on the secondhand market—where the property is dismantled or devoted to some other use—is not very substantial.

Take the case of an asset having, say, a 3-year life. Personally, I would favor just ordinary straight-line depreciation for the 3 years. I can't see too much point to special quirks and gimmicks in connection with a 3-year-life proposition. You mentioned the question of capital gain. That undoubtedly is an arguable point as to how our final settlement should be made, how it should be handled with respect to the taxpayer on disposition of some property.

Mr. MILLS. I have had occasion to read the Treasury regulations, the proposed regulations in connection with section 167, and Mr. Williams, of the Treasury, is to be commended for having attempted, if the regulation can stand, to solve this problem of the Cadillac automobile that Mr. Othman referred to by application of salvage value. There is some question whether or not the regulation carries out the expressed intent of the Congress as reflected by the Finance Committee's report with respect to whether or not salvage value is applicable in the instance of the declining balance and sum of the year's digits methods.

Mr. PATON. I don't know that this has much bearing, but I have never sympathized with the idea of merging successive transactions as we have done sometimes. That is, I like to terminate my accounting, generation by generation, as units of property are retired, even where the retired unit is traded in in acquiring the new unit.

Mr. MILLS. Mr. Paton, I believe we would be satisfied with section 167 and with the regulations which I have read, if we would say that the declining balance method, sums of the years' digit methods, and any other consistent method, and so forth, of subsection B shall apply in the case of property, other than intangible property described in subsection A, with a useful life of at least 7 years or 10 years rather than 3 years. Before the last Congress adjourned I introduced a bill to eliminate the rapid amortization features of the law, and to increase this to 10 years. I said 10 years, because I knew that there would have to be some compromise between 3 and 10, or some other time.

I notice my good friend from Missouri, Mr. Curtis, also introduced a bill before Congress adjourned to eliminate the so-called rapid amortization, certificates of necessity.

I think both of us were prompted to do that in the light of the statement made by the Secretary of the Treasury himself, that further consideration should be given to the question of continuing at the present time the issuance of certificates of necessity. I don't know whether he was thinking in terms of the effect upon revenue, as Professor Eisner is thinking in his statement to some extent, or what prompted him to make the statement, but it seems that the time has arrived when we should think in terms of eliminating that, just as we thought in terms of eliminating the excess-profits tax in peacetime.

I think there is about as much reason for an excess-profits tax in peacetime as there is for certificates of necessity in peacetime, and I see no real necessity for either one in peacetime.

Mr. PATON. I am inclined to agree with you, Mr. Chairman.

Mr. MILLS. Mr. Terborgh, would you comment on that?

Mr. TERBORGH. You are still on these three questions, Mr. Chairman?

Mr. MILLS. That is right.

Mr. TERBORGH. I assume the alternatives that you are posing are the new methods in section 167, as against the continuation of the old straight-line procedure.

Mr. MILLS. That is right.

Mr. TERBORGH. First, as to economic growth, I don't consider that aspect debatable. It can't be denied that more rapid tax depreciation is stimulative of economic growth. That, indeed, is why it has been invoked in so many countries abroad.

As to the stabilization effects, I agree with Professor Brown completely: If there is any net disadvantage in these new methods from the stanpoint of economic stabilization it is negligible. We get somewhat different results with different suppositions as to the pattern and length of a possible depression, but the net disadvantage is generally slight and can be disregarded.

I am happy to agree also with Professor Brown's comments on the effect of the new methods on small business, as compared with large. I think it quite obvious that accelerated depreciation is relatively more beneficial to small than to large business, for the simple reason that small enterprises are far more dependent upon their own capital resources.

It is perfectly true, of course, that a new operation that incurs initial losses will get no immediate benefit from larger deductions. With the present 5-year carry-forward, it will, however, be building up future deductions from which it can derive benefit as it gets into the black. With this reservation as to completely new enterprises, I can say categorically that the new methods promise more benefit to small than to large business.

Now for the second question, which has to do with the allocation of resources. On the assumption on which I proceed, that the new methods are by and large legitimate and realistic the case is clear that they provide a more equitable and beneficial allocation of resources.

A retarded writeoff method is prejudicial to enterprises and industries that have heavy fixed asset investment as compared with the inventory industries or lightly capitalized industries generally. If the new methods are more realistic than the old, they accomplish more equity as between various industries and a better allocation of resources between them.

That is all I have to say on the three questions at the moment.

Mr. MILLS. Would any of the members of the panel desire to comment further on anything that has been said to this point by other members of the panel or by me?

Mr. TERBORGH. Since that invitation opens the floor, may I go on to make a couple of comments on previous observations by other speakers?

Mr. MILLS. Yes.

Mr. TERBORGH. As to Professor Eisner's estimates of potential revenue loss, they are much higher than those I have developed on what I believe is a more adequate basis. Far more important even than that is the fact that they are estimates of gross loss and not of net loss.

If the application of these new methods provides industry with more immediate capital funds and results in an expansion of investment, with an improvement of the productive facilities of the country, it generates an expansion of the taxable base. No calculation of the revenue loss should be simply a gross calculation.

If we attempt to offset against the gross loss the revenue benefits from a more rapid expansion of the economy by reason of heavier capital formation, we can come up with quite different answers. I don't urge my own estimates. They are highly conjectural. I have played with various sets of assumptions, however, and have deduced patterns of net loss quite different from Professor Eisner's, which show gross losses rising for 10 or 15 years ahead. After offsetting the effect of the increase in the tax base, net losses are actually a tapering magnitude, becoming negligible after a few years. The only point I want to make is that this reckoning of gross losses without the countervailing gains is a misleading reckoning.

Mr. MILLS. May I ask this question and obtain your comment on this point?

If tax rates remain the same over a 20-year period, and if you have a growing economy in which it is expected that profits will be made year in and year out by businesses enjoying depreciation, in the long run, over the period of 20 years, does it make any difference to the revenues derived from that business, say, in that 20-year cycle, as to which method of depreciation you use?

It may well affect the taxes paid within a given year, but as it decreases the tax paid in a given year it may well increase the tax paid in a subsequent year under the circumstances outlined.

Mr. TERBORGH. On that point, I am quite in agreement with Professor Eisner, that if the business is growing, and continues to grow, its deductions under the new methods will continue to be larger than under the old methods indefinitely. There will be no complete catching up. There will be such a catching up, however, on a stabilized operation.

Mr. MILLS. Of course, in a growing economy——

Mr. BROWN. Do you mean that?

Mr. TERBORGH. I mean exactly that.

If a business were to have a stable capital account for a period of 20 or 30 years, its current accruals by the new methods would come together with the accruals by the old method.

Mr. BROWN. But you would never catch up with the transitional depreciation.

Mr. TERBORGH. It will never catch up with the differences accumulated during the transition. I am saying the two accruals will eventually come together under a stabilized operation, but that doesn't mean a compensation for the differences prior to stabilization.

Mr. MILLS. Let's talk about the example I gave, tax rates remaining the same over a 20-year period, Bulletin F says that this item bought in 1955 has a useful life of 20 years. You can take the straight-line method. You have charged off the cost of the asset to the business to the extent of 5 percent a year of the value of the item depreciated.

If you use the declining-balance method, or the sum-of-the-years digits, you may place more of the depreciation in the first years, but as a result, you are receiving less depreciation in the latter years, so that over a period of 20 years, it is entirely possible that the business might pay approximately the same amount of tax regardless of the method used.

Mr. TERBORGH. That is true of a single property, on the assumptions stated, yes.

Mr. MILLS. On a single property.

Senator DOUGLAS. What about the investments made in 1956 and 1957 and 1958.

Mr. MILLS. That is the point Mr. Brown and Mr. Eisner discussed.

Mr. TERBORGH. There I come back to the statement I just made. If the annual installations are of the same type of property and are constant in amount over a series of years, and if the company depreciates by the new methods, it will find that the accrual is higher for some time than it would be by the old method. Thereafter the accruals will be the same by both methods.

Senator DOUGLAS. On that piece of property or on that capital investment, but what about the additional increment of capital investment coming in successive years? They will receive it. Do you not always eat into the future, so to speak, and therefore effect a permanent transition?

Mr. TERBORGH. You are getting more depreciation on your young assets and less on your old assets. As long as the age composition of the account is weighted on the young side, you will get a higher total accrual by the new methods than by the old. As soon as you get a stabilized age distribution, as you will if you keep on making level installations over a period of years, the two accruals will come together.

They will be identical thereafter, although, as Professor Brown has pointed out, there will be no compensation for the difference between them prior to the attainment of the stabilized account.

Senator DOUGLAS. At the end of what period would you get this stabilization? Not at the end of 20 years?

Mr. TERBORGH. Taking a very simplified example, if each of these assets has precisely a 20-year life, then you will reach stabilization after the account has run for 20 years, but if you have a mortality distribution around that 20-year average, with some surviving for 30 or 40 years, you won't get complete stabilization until after a period equal to the service life of the longest lived asset in the account.

Senator DOUGLAS. Do you agree with that, Professor Eisner?

Mr. EISNER. Yes. I think you have to distinguish carefully, as Mr. Terborgh was distinguishing, between the adjustment period—that is, the transition problem—and the growth problem. On the assumptions the chairman is indicating, of a stable rate of acquisition of assets, you simply have the transition phenomenon. So, for example, if all properties were lasting 20 years, then over a 20-year period each firm, with property of this kind, would have higher depreciation charges in each of these first 20 years, and would hence pay lower taxes, other things being equal in each of these first 20 years. Then after the 20-year period, this firm would pay the same taxes, have the same depreciation charges in each of these succeeding years, under the rapid depreciation as under the old straight-line depreciation. However, there would not, therefore, be any catching up. This firm

would have saved taxes for 20 years which they would never be caught up with, except in the possible case of dissolution. I don't quite see how that would affect it anyway, because probably the tax situation would be different for a firm liquidating.

Senator DOUGLAS. Do I understand you to say there are transitional gains to the company during this intervening period, so that the ultimate period of stabilization does not remove these transitional gains?

Mr. EISNER. That is correct. It is curiously analogous to a provision which I believe the Congress has eliminated, in terms of anticipating future income, or in regard to future costs on prepaid expenses. There is a doubling-up process here in this transition, so you are, in effect, getting your regular depreciation charges on your older properties, and in addition, are getting large depreciation charges on your newer properties.

Senator DOUGLAS. I wonder if we could have a little further discussion on this question of growth, and the effect upon revenues.

Mr. EISNER. Yes. I think Mr. Terborgh's point is well taken, that ultimately one would have to consider the net effect and not the gross effect, but my view is that these net effects become very questionable. This relates to one's view of how the economy operates and what these effects will be. I think it is good clarification to at least begin by assuming that we don't know the net effects; that is, you don't know what the effect on the economy, and hence capital expenditures will be, and assume the capital expenditures would be the same under rapid depreciation as under the old depreciation.

With this assumption, if the rate of capital expenditures in dollar terms continues to grow, as it has in the past, then there is not only the point that there will be no catching up with the higher depreciation charges, but the higher depreciation charges will keep recurring year after year and taxes will be less year after year for firms affected.

I would like to suggest to Mr. Terborgh that it does seem to me that our country in the postwar period in particular, and for a very long time, has shown a very rapid rate of growth and I believe Mr. Terborgh has argued on a number of occasions that we have shown a more rapid rate of growth and a more rapid increase in capital plant than the countries to which he has referred to as Socialist countries—which have the more rapid depreciation charges.

And I think there is a very serious question whether increase in depreciation charges will actually affect the economy in such a way that capital expenditures will be increased. Clearly an individual firm will have an added inducement, but in trying to make a prediction for the entire economy, you have to go through all of the ramifications for this and higher depreciation charges if they mean higher taxes on other individuals may actually have a rather deceptive effect.

They may affect demand in such a way that the results will not be fortunate. It does appear to me, too, that we have something of a record of a problem of American industry expanding, perhaps more rapidly at various periods than demand seems able to keep up with, and to the extent we have this problem this doesn't eliminate it. It doesn't ease it to encourage higher depreciation charges any more than it does to encourage the propensity to save, as economists have referred to it, generally.

Mr. Terborgh. May I offer a rejoinder to those observations, Mr. Chairman?

In the first place, I cannot for a moment accept the proposition that the next tax losses would equal the gross losses. It seems to me almost axiomatic that higher current deductions will generate larger capital expenditures, and will accelerate the rate of growth in national income, hence in the tax base.

Secondly, the mere fact that business capital formation in the United States may be higher than in some Socialist countries that have granted accelerated depreciation, is evidential of nothing except that we have a noncomparable comparison. The real question is: Will business capital expenditures in this country be higher under the new methods than they would be under the old?

As for the overcapacity bogey, I can't accept that either. The principal effect of stepping up the rate of capital expenditures is to step up the rate of improvement in the technology, to step up cost reduction, and there is no necessary reason for it to generate overcapacity. It can have the effect of a more rapid extinguishment of existing assets, and in general I think that would be its primary effect.

Senator Goldwater. Might I ask a question there?

Mr. Mills. Yes, Senator Goldwater.

Senator Goldwater. Wouldn't more danger exist in the capital not keeping up with demand, than capital getting ahead of it?

Mr. Terborgh. We have that problem today. Obviously, we are short of capacity in many important basic industries. There is very little evidence of serious overcapacity anywhere, notwithstanding 10 years of very heavy capital expenditures.

Mr. Mills. I wonder if—and this is addressed to all members of the panel—I wonder if the difference in viewpoint that exists with respect to this matter of depreciation does not arise from a difference in viewpoint as to the theories for depreciation?

The basic underlying objective causing it to be written into law, in other words.

You can't get away, in my opinion, from the legalistic concept of depreciation, which is written into the law, applicable to individual pieces of property, for the purpose of allowing a deduction incident to exhaustion, wear and tear.

We are talking about an individual piece of property. We put this in the law because we do not want to limit the recovery of the capital costs of depreciable properties to profits after the payment of taxes. We put it in there to accord a greater opportunity for the recovery of the original investment out of the gross income of the business before taxes apply.

That is the legalistic concept in the law and we are talking about an individual piece of property.

Now in the light of that then we may look to it to see what effects it may have upon revenue, what effects it may have upon economic growth, upon stability, upon all of these other adjuncts but we cannot avoid in my opinion in our consideration of depreciation from these other points of view, the original basic, legalistic concept of depreciation, namely, to provide a means of more readily recovering the capital investment out of the gross income of the business before taxes apply.

Now, do we agree that that is legalistic concept or not?

Mr. Paton. May I word it slightly different?

Mr. MILLS. I am sure it would be better worded.

Mr. PATON. No, sir; you are very polite.

Mr. MILLS. That is my thinking about why we have depreciation.

Mr. PATON. I agree, but I always like to put it this way: that we have depreciation as a deduction because the consumption of plant capacity is just as much a cost of production as the consumption of materials.

In other words, we are trying to measure income by deducting all of the costs, and of course if you do not collect money from customers to take care of the replacement of materials you won't be able to do that, and if you do not collect the money from customers tax-free to replace plant capacity you won't be able to do that.

Mr. MILLS. You are approaching it from the point of view of an accountant?

Mr. PATON. That is right.

Mr. MILLS. Mr. Curtis?

Mr. CURTIS. Picking up there, I would comment that I think it is a more basic thing than even that as far as law is concerned because under the 16th amendment Congress is not permitted to make capital levies, and an attempt to tax a return of what amounts to the wear and tear of capital, capital return, would actually be a capital levy.

I think that we are confined in that regard.

This is getting to the basic question I have, Mr. Chairman. I am not entirely sure that from reading these papers of Mr. Brown and Mr. Eisner and those of Mr. Paton and Mr. Yerborgh, whether there is real agreement on depreciation.

I am quoting some of Mr. Paton's language where he says "Depreciation is an actual explicit cost and not an assumed or hypothetical charge."

I wonder if Mr. Eisner or Mr. Brown would agree with that, because I have some doubt in my mind from reading their papers whether they do agree with it.

Do you believe that depreciation is an actual and explicit cost, and not an assumed or hypothetical charge, Mr. Eisner?

Mr. EISNER. Well, the cost can be viewed as the cost of the acquisition of the property.

Now the depreciation accounting is a method of accounting for that cost. The cost is then something that occurred when you buy the property.

Mr. CURTIS. It is something actual, not hypothetical. In other words, you have a specific piece of property, and depreciation is simply a measure of how that has been consumed; is that right?

Do you agree with that?

I am not sure. That is why I asked the specific question of both you and Mr. Brown, because from reading your two papers, I was not sure that you did agree that it was something actual.

Mr. BROWN. I would say, "Yes." There is no difficulty there, it seems to me. If I were to define depreciation, Mr. Terborgh, Mr. Paton, Mr. Eisner, and I would all define it in about the same way, that definition still would not force me to a position with regard to tax policy, which involves broader issues.

Mr. CURTIS. Believe me, I am not trying to develop anything other than what would be logical.

Now then——

Mr. BROWN. I do not think there is a difference there.

Mr. CURTIS. I noticed in your statement, Mr. Brown, you referred to what is normal depreciation, and I assume in saying that that you regard the accelerated depreciation as above normal, which would mean it is unrealistic.

Mr. BROWN. This is obviously not a question of principle, but a question of fact as to whether existing measures do measure the decrease in value of an asset.

Mr. CURTIS. That is fine. We can get someplace, I think, because we get back to an actual study, somewhat along the lines Mr. Terborgh has made, in the tables that he has put in his paper, which are an attempt to actually measure specific pieces of property to see whether the accounting systems are realistic.

In other words, do they really measure what is the using up of the properties?

The reason I was concerned, Mr. Brown, on page 496 of your paper, you indicated that the reason for the change in the 1954 tax—and I will quote you—was clearly designed to speed the rate of economic growth rather than to improve the equity of the income tax.

I was one of the main promoters of the new schedule, and I certainly sat through all the hearings and I think that is exactly wrong.

Everything that was presented to us, most of the arguments were on the basis of accountants who were saying that our business accounting, which was actually trying to be realistic, was out of step with Government depreciation, or the tax laws required them to be, and the arguments were all based on a plea for making the more realistic accounting systems of business—at least that was their allegation, making our Government accounting conform to them.

Mr. BROWN. Let me tell you the basis for that statement. I have not the benefit of having sat through the hearings. I read the hearings, and looked primarily to Treasury motivation, as far as these accelerated depreciation proposals were concerned. I was impressed by the fact that almost every statement of Secretary Humphrey, or of then Under Secretary Folsom, was directed toward the need to encourage growth, and only as an afterthought, it appeared to me, was the subject of the measurement of income mentioned, whether this method was more realistic or not.

Secondly, if it really is an improvement in the definition of income then it should surely not be limited to new assets.

Mr. CURTIS. I might state the only reason for limiting it to new assets is exactly the point that has been brought out here.

You have problems of transition, and in that period of transition we would meet with some revenue problems.

We all recognize that when we consider it, and that business of limiting it to new assets was solely to relieve the impact on revenue in the transition period.

It had nothing to do with any relation to realism.

In fact that was a perfectly arbitrary decision, as I say, based on revenue needs.

Mr. BROWN. Then it creates an inequity between those who have existing assets and those who buy new ones.

Mr. CURTIS. There is no question but any system when you change from one to another you are bound to produce certain adjustments and any adjustment is going to have that effect. I think we recog-

nized it at the time we made the decision, and it was purely arbitrary, but it was felt—I am now saying so in spite of what Secretary Humphrey and the Treasury might have presented—I think and hope the Congress still writes the laws.

We listen to what the Executive has to say and if we think it is good we are apt to go along with it, but I do think that the reasoning presented to the Ways and Means Committee in the discussions in the Ways and Means Committee were based on what was more realistic and our feelings really went right along the lines of Mr. Paton's paper, that we felt——

Mr. Brown. Mr. Paton's?

Mr. Curtis. Yes, his paper here. The logic that appeared in his paper was the logic I think Mr. Mills would agree that we had in mind and were considering at the time we made this change.

I think that some of our differences between the approach of the two papers actually lies there, where Mr. Brown and Mr. Eisner assume that the purpose in mind was to stimulate investment, rather than to bring about more realistic accounting.

Now maybe we did not do it, but then the test is let's re-examine these specific items, just as Mr. Terborgh has, to see whether it is more realistic. That is the thing I am interested in.

Mr. Terborgh. May I make a comment?

Mr. Curtis. Yes, sir.

Mr. Terborgh. I think Professor Brown has a generally valid point. The official rationalization of the new methods has invoked primarily their stimulative effect on the economy rather than their realism.

Mr. Curtis. You mean the Treasury's presentation?

Mr. Terborgh. Yes. I think even the committee reports emphasize that point of view. I have always regarded this as regrettable, because incentive or subsidy depreciation obviously rests on a much less secure footing than does a legitimate realistic writeoff.

Mr. Curtis. I am glad to get that observation because it may be I am the one who is out of step on the Ways and Means Committee.

I will tell you right now, on the basis of incentive, I never would have supported it, because my sole object was to get more realism into this and those are the arguments I was concerned with.

Now I will say this: However, there was this one thing that I was concerned with from an economic angle and I want to throw this out for possible discussion.

The fact that we found, or at least it was presented to us that in industry there was an incentive to repair old machinery, because the cost of maintenance and repairs, of course, could be deducted from ordinary income instead of junking the machinery and going and doing what their economic judgment would have been, to have gotten new machinery.

To that extent, I will say that I was motivated by a concern with the fact that we were not making what seemed to have been normal and good replacements, because the tax structure was interfering with a free judgment on the part of our business executives.

Mr. Paton?

Mr. Paton. I would like to make just a comment there because I think that is a very important point.

I am interested as an accountant in realism, that is, my whole interest is in reasonable accounting.

Perhaps I had better say reasonable accounting, rather than absolutely accurate accounting, because there are judgments in it.

You have touched on something that is extremely important. What is realism with respect to the service life of a particular unit of property?

Most assets, business assets, are not used to the point that they absolutely have to go over the cliff. A decision is made to replace when the asset is still functioning, and therefore, realism in a sense does include replacement decisions, so that if we shorten service life, or if we accelerate writeoff, we are inevitably thinking of a growing economy and thinking of an economy where we want business people to have confidence that the tax system is not going to confiscate capital, and that they will be prepared to lean toward early replacement rather than tinkering and repairing indefinitely.

That is one reason I am so interested in a point that I sort of specialized in here—the people that hold these older assets, which are still a large part of our total capacity.

They are repairing in many cases because they just do not have the funds and the incentive, in my humble opinion, to make thoroughgoing replacements.

That is, realism is partly a question of what constitutes good management in view of our desires for the economy.

Mr. CURTIS. That is right.

Incidentally, I am motivated somewhat along the lines that you expressed.

I want to have our tax laws so written that we can leave as wide a discretion in the hands of the business people to make these judgments on what they think is right.

I might say that you are touching on the other point I was going to develop just a little bit, that the discusison was through investment stimulation as suggested here.

I was thinking that the stimulation would come more from, as I say, a removing of this tax deterrent to buying replacement of new machinery, instead of using say $60,000 to fix up a new machine, to maybe spend a hundred thousand dollars on a new and better one.

There is where I saw that great growth might come out of the more realistic approach to depreciation, and I think that that has shown itself to be so.

I would like to throw out a syllogism here. We were discussing whether small business—whether there was incentive to small business in this area.

I personally think there is. I was on the Small Business Comittee of the House in the 82d Congress and we held hearings all over the country and one thing I became convinced of was this depreciation schedule that we had then was not stimulative.

I think it is very true that maybe small business does not benefit from our rapid depreciation because they will take their investment early when they are not making money and then when they do get going and making money, they do not get these writeoffs, but the incentive to invest in small business is deterred by the fact that any small business is going into a risk venture. You talk to these investors. I have many times, fellows that will put money into small business. They are anxious to minimize that risk and they want to

get that money back early. That is why this thing is an incentive to them and I actually believe, as I said in argument both in the committee and on the floor, that we are going to make more money, the Government—we are going to have a bigger tax take, not a less tax take, because of this tremendous drive to get their risk money back, and then when they are really making money they won't have as much to deduct.

I think that—I pose that as a counter suggestion on our discussion on small business.

Mr. PATON. I would like to echo that, sir. How important it is for the country as a whole I could not say, but I think we should all realize this: That you may actually have a high level of incentive under a tax system in which the total tax take is larger than it would be under another system because of the minimizing of risk, the very thing you mentioned.

That is, in an era of very high business taxes there is, of course, I think, a discouragement, aside from the fact that funds are used up that might go into venture money.

There is some discouragement. Now you put a floor under that discouragement, or reduce it a bit.

In the old days the big incentive was, "Sure, maybe we would have losses if we tried making this kind of mousetrap rather than the other one," but ever little while there was a Henry Ford or Coca-Cola or somebody.

Now, when you have high taxes, the jackpot inducement is minimized in this country.

What can we do then?

We can perhaps schedule our depreciation allowances in such a way that there is a greater feeling of assurance that the risk in the early years is minimized.

I think, actually, just looking at a particular business, rather than the aggregate economy—and, of course, those are two somewhat different questions—that a tax schedule that may take more taxes in the long run from that particular business may, nevertheless, have more incentive in it than one that takes less.

Mr. CURTIS. I am very happy to get your observation. Those were conclusions I had tended to reach at any rate. Did you have a comment, Mr. Terborgh?

Mr. TERBORGH. I was going to add this: That the benefits of these more rapid writeoffs are bilateral. We have a scissors effect. Industry is given more capital funds to spend. The supply of funds is enlarged, but the demand is also enlarged because it is more advantageous to invest in new assets.

I have made some experiments to try to find out the probable effect on the economic service life of equipment, and I think it can be demonstrated quite satisfactorily that sum-of-digits depreciation will knock at least a year or two from the average economic life of capital equipment, as compared with straight-line. So it not only amplifies the supply of funds; it makes it more advantageous to use the funds in reequipment.

Mr. CURTIS. Thank you.

Now, just one thing to echo Mr. Mills' discussion on the salvage: I wasn't so concerned about the Cadillac, although that illustrated

the point, as that particular problem and the importance of salvage came up in the drive-it-yourself car industry for example. I thought the Treasury came out and did a very fine job in their definition of salvage, "no longer useful in the taxpayers trade or business," because to use that particular industry, they buy brand new cars, but in order to do their job they are going to get rid of that car in about a year because their customers don't want to drive a car that is over a year old. So their actual investment really is the difference between their price and what they are selling it at.

Obviously, that car that they sell—and they sell a lot to the used-car market—has considerable value, and useful life, but it is the useful life in the taxpayers' trade or business. I may be wrong but I think that the Treasury is well within bounds of the legislation that we wrote.

I might say that if they are not, I am very anxious to correct it because I think that should be corrected.

Mr. MILLS. I didn't intend to convey the impression that I didn't think the Treasury, too, was within the bounds of the regulation. I raised the question of whether or not the Treasury was within the bounds of the Finance Committee report.

Mr. CURTIS. I see.

Mr. TERBORGH. May I comment on that salvage question for a moment?

There was a loophole in the interpretation of section 167, in the provision that the declining-balance method should be applied without a salvage estimate. That permitted assets to be written down below their resale value, and the taking of a long-term capital gain under what used to be section 117 (j). (I have forgotten the present designation.)

Mr. MILLS. 1231.

Mr. TERBORGH. That loophole is plugged in the tentative regulations now issued by the Treasury. These limit the total cumulated amount of depreciation by the declining-balance method to the excess of cost over salvage.

I hope that solution will stand legally because it is the simplest way out of the predicament. If it doesn't stand, however, the language of the committee's report, which implied that declining-balance depreciation can be taken on full cost in disregard of salvage, should be corrected by reinterpretation or by legislation, if necessary.

I go further and say that if section 1231 constitutes an obstacle to the application of the new methods to relatively short-lived assets, the remedy is the correction of the section, not the restriction of these methods to assets with 10 years or more of prospective service life. As far as I can see there is little difference between the characteristic value runoff of short-lived and long-lived assets. Indeed, if there is a difference, short-lived assets lose a larger percent of their original value in the first half of their life than do long-lived.

I should deplore very much any restriction of the application of the new methods to assets of 10 years and over. Five years and over might be a compromise. There is quite a lot of stuff falling in the 5- to 10-year category and it should be eligible for the new methods. I repeat, if section 1231 is a stumbling block in this connection the remedy is to correct it.

Mr. MILLS. That is the difficult part to remedy.

Mr. TERBORGH. As you know, it was a wartime device to meet a tight secondhand market wherein the Government wanted a lot of redistribution of secondhand equipment. It was valued so high in that market that the holders didn't want to pay excess-profits tax rates on their realized gains. Section 117 (j) was the solution. But the war is over and I don't see any compelling necessity for continuing it if it aggrieves the Treasury.

Mr. MILLS. Without repealing the cause of enactment of 117 (j).

Mr. PATON. Just a trivial comment on this point, which probably isn't worth getting off. I am not too familiar with the new regulations though I have been dipping into them, but I would predict that the Treasury will hold up all right on its regulations in this particular, for this reason. That all through our history, all through the history of, say, 50 years of discussion of depreciation, it is always implied at least that it is cost less salvage that really is the cost you are depreciating.

True, in many cases, the difficulties of estimating what the salvage may be in excess of demolition cost, for long-lived property, has led to the rough canceling of possible estimated salvage against demolition cost, but it is an old story with the Treasury, even. In situations where there is a large salvage that can be demonstrated, the Treasury has never been obliged, as a matter of practice, to ignore salvage, so I feel quite confident that they will go along with that all right. That is just my guess, in view of the past history of the whole thing.

Mr. CURTIS. I had a question on certificates of necessity. I posed the question whether that wasn't pretty realistic for the situation we had in wartime. What we were doing as I saw it, the Government, of course, was giving this incentive. There is no question about it, because that all would flow into that particular area where they got these writeoffs. But it was because we estimated there was going to be economic waste.

In other words, we are going to build plants that after the war would have no market for their products, and it was the fact that any investor would be left holding this particular plant which would not have any further useful life as it were. The reason I am opposed to the thing in peacetime is that I think there is no need for as much waste.

Certainly, we can do a lot better planning, not in emergency, and we can do a lot better planning and so there is no need for giving any taxpayer or any corporation a lifetime that is so limited, because it need not be that wasteful. I just wanted to interject that. The final thing I wanted to comment on is to me very basic, and has to do with all this talk about loss of revenue which I honestly don't understand, and don't believe, to be very frank.

I think that the only way we can understand the revenue is to take what the law is, which is each item, and as you ring each particular item through you find that you can only take the cost value—I don't care what method of figuring it out you use. If it costs $100, you are only going to get the cost of $100 back; that is all you can ever take as a deduction. It is true that in the switch period, when you switch from one system to another, there is an initial loss in the switch, or can be, and even that loss, of course, would ultimately be gained back in theory.

It comes down, I think, to this, and this is what I would be glad to have comments on: When we get away from the individual item or items that go to make up your total depreciation deductions; that is, where we begin to lose this picture. We go on the assumption of this growth that we are talking about, and of course, if the Nation is growing, the more is going to be invested in assets that have depreciation, and the depreciation claims are going to increase. But it also means that your GNP obviously is going up considerably. But I don't think we can take economic growth just as a monolithic thing. There are some firms that are growing and some firms are waning. Firms die. I have been impressed with the figures showing the hundred large corporations back in 1900 and then taking them on through the period, to see the change. Just as the buggy business used to be a big business at one time, I guess horse raising, and so forth, used to be; interurbans are no longer in existence. Interurban companies are gone. If any company goes out, their total depreciation to the Government from the tax angle catches up and this turnover occurs within something that is growing, I think, over a period of years. We don't even have to project it beyond a generation.

Probably most of this original loss in the switch would have come back, but I can't for the life of me understand, Mr. Brown, or Mr. Eisner's presentation on this overall loss through depreciation if we are referring to what I start out with, an actual, explicit cost, and not something which is assumed or hypothetical. If it was something assumed or hypothetical, I could understand it, but if it is actual and explicit and is made up of individual items, I don't see how there can be any differential as far as taxes are concerned.

Having said that, I would be glad to hear Mr. Eisner and Mr. Brown.

Mr. Brown. One question just before that. I think Mr. Terborgh would agree, too, wouldn't you, that there would be a permanent revenue loss, depending upon what assumptions you make about the stimulating effect, and so forth?

Mr. Curtis. That is what I don't understand from a revenue standpoint.

Mr. Terborgh. In a growing economy, accelerated methods as against straight line——

Mr. Curtis. Let me stop there, because I thought we agreed that "accelerated" was used on the assumption that it was not realistic. If it is realistic, then it is not accelerated.

Mr. Terborgh. I agree wholly. It is better to call straight-line depreciation decelerated. The new methods are accelerated as compared wtih straight-line, not as compared with a realistic writeoff.

Mr. Curtis. To me there is your test. If it is not realistic, I agree you would do a lot of things.

Mr. Terborgh. I mean accelerated in the sense they write off more cost in the earlier years than in the later years of life. Such methods, if applied consistently in a growing economy, will generate indefinitely a larger current accrual than a more retarded method.

Perhaps this can be made clear by saying that in a growing economy we always have an overweighting, or preponderance, of young assets. Because of growth, young assets are added faster than old ones are retired, hence the age composition of the stock at any given moment

is overweighted on the young end. Since it is the young assets that get more depreciation by these accelerated methods, and the old that get less, this overweighting of the young end of the age spectrum results in the continuous generation of more depreciation by the fast writeoff method than by the slow.

Mr. CURTIS. Let me ask the two things that I pose: No. 1, obviously, you are assuming your GNP increases, but above all, getting back to this basic thing, you have in this growth some concerns that are dying as others are growing. Some are waning as others are waxing, and there is this interplay within this.

Mr. TERBORGH. I pointed out that any estimate of revenue loss is simply a gross calculation. It takes no account whatsoever of the offsetting benefits arising from the depreciation method itself. When we take account of these offsetting benefits we get a quite different story.

Mr. CURTIS. Wouldn't it be true under any accounting system during a period of growth, you are obviously going to have more depreciation deductions, under any accounting system?

Mr. BROWN. Yes.

Mr. CURTIS. Then it has no relation to this particular system.

Mr. EISNER. I think we should distinguish between what the effects are and what is desirable. I believe Mr. Curtis' point is that it is desirable to have more rapid depreciation, because it reflects, in his opinion, the actual depreciation value in terms of property.

Mr. CURTIS. I want it realistic.

Mr. EISNER. This may well be so. We should explore the arithmetic and realize, desirable or not, it has a very definite effect, as Mr. Terborgh has indicated I think very well, and I suggest—I think I originally got the idea from some of his earlier writings. It has this very definite effect of increasing depreciation charges year by year, as long as this growth phenomenon continues, and one can actually construct any number of simple arithmetic examples to demonstrate it or perhaps more practically simply work with the accounts of almost any firm.

I suggest, if you pick any firm at random, certainly any well known firm over the past 20 years, and offer the test of what depreciation charges would have been in that firm, had we applied these rapid methods, beginning in any period we select——

Mr. CURTIS. A waning firm?

Mr. EISNER. For a waning firm throughout the period of transition there will be a higher depreciation charge, and then lower depreciation charges, but the fact is, if you look at the economy as a whole, clearly the growing firms are outbalancing the waning firms.

Mr. CURTIS. The point I make is that you can't look at the thing from the standpoint of the overall because depreciation applies to individual pieces of property, and those individual pieces of property in turn are owned by firms that either die or go out of existence—some of them do, some of them grow, but the overall picture is this birth and death.

Mr. EISNER. We are simply suggesting what the Treasury should recognize, and I believe it has in some of its estimates, must inevitably happen for the economy as a whole. This will be the picture, on the assumption which curiously you are willing apparently to make, that you will disregard the incentive effect.

I think the answer to this, as Mr. Terborgh has indicated, is if there is an incentive effect which will increase capital expenditures and increase national income, the total net effect may not be what we suggested, but to the extent you feel this is not the issue—you have indicated that you are disregarding incentive effects—then I think there is absolutely no escaping from the arithmetic.

Mr. CURTIS. I am simply trying to get a realistic accounting system that reflects what is, and the reason I say, of course, there is no revenue loss is because this very process of growth we are describing indicates that your GNP is going up. That is our tax base, if you get right down to it. The best proof I know is, I think it is in your paper at the conclusion, where you say we are going to have this revenue loss, though we haven't shown it.

Quite to the contrary, we are showing a terrific revenue gain, and I would suggest it is coming from this increase.

Mr. EISNER. When I say a revenue loss, I don't mean the Treasury revenues will go down. This surely depends upon what happens to national income. What I mean is there will be a loss as against what there would have been with the old depreciation, assuming that, however national income rose, the rate of growth is not affected by this, which is what I think you suggest in terms of ignoring the incentive effect.

Mr. CURTIS. No. I will ignore the incentive, but I certainly won't ignore the fact that you are basing your premise on a growing economy. That is where you say the loss will occur. I say if you presume that, you have got an increased GNP, so obviously there is no revenue loss. I say your own arguments are the ones that come up to defeat you.

Mr. TERBORGH. Could I add an observation there? You raised, by implication, a point that has not been mentioned by any of the panel and I would like to emphasize it. Even a system that is precisely right and realistic is nevertheless loaded in favor of the Treasury. If you live, the Treasury will get you, but if you die, you may die with a lot of unrecovered asset values, or undepreciated balances that will never be taken tax-beneficially. You mentioned industries like electric interurbans that have been disappearing with the progress of technology. Such disappearances result in a lot of depreciation deductions being taken nonbeneficially as terminal writeoffs of property. I should suppose that the terminal-property losses of companies and industries going out of businss may run to billions a year.

The electric interurban industry, for example, died with several billions of net property. They should have depreciated it previously, but since they hadn't done so, the whole thing was a total loss.

Mr. CURTIS. I get your logic, I think. Therefore, when you provide a quicker taking-off, there won't be as much of this loss to industry?

Mr. TERBORGH. To state it otherwise, the Treasury can be generous in the writeoff methods it allows and still break even, because the dice are loaded in its favor.

Mr. CURTIS. Thank you very much. That is very helpful.

Mr. MILLS. Senator Douglas?

Senator DOUGLAS. Well, I had always thought that depreciation was as, I understand it, Mr. Paton finds it to be, a physical phenomenon, or the relative rate at which capital goods are physically used up. I

distinguish it in this case from obsolescence, which is an economic factor rather than a physical wastage.

I had also thought that the various service lives that the Treasury had recommended in Bulletin F as the norm were probably excessive, and hence that the annual allowance for depreciation, if a company followed the Bulletin, would have been inadequate. I was somewhat struck by Dr. Paton's statement that he thought that the Bulletin had not fixed an excessive period of time for the physical life of these properties, or possibly that administrative adjustments in the field may have corrected inequities.

I wonder, in view of the charges which have been made, that Bulletin F fixed too long a physical life of these properties; I wonder if you would be willing to expand your answer, Dr. Paton?

Mr. PATON. Well, Senator, I am, I suppose, no expert on what service life is.

Senator DOUGLAS. I have always regarded you as one of the 2 or 3 foremost accountants in the country, and if you are not an expert, who is?

Mr. PATON. I was going to say that I perhaps can't pose as an expert on what actually is the experience with respect to this type of property or that type of property. I have gone over some of that material, but it has been my impression that, in general, the Internal Revenue Service has been reasonable, a bit liberal, but not too liberal, in my opinion, with respect to service life; in view of the risk factor, I feel that we ought to be liberal.

Senator DOUGLAS. I understand. I am simply struck with the fact that you seem to believe that the length of life or service life which the Internal Revenue Bureau has attached to various pieces of physical property and which generally runs between 15 and 20 years, conforms roughly to the reality of physical wastage, and I am simply speaking of physical wastage.

Mr. PATON. I think 15 or 20 years isn't appropriate for certain classes of property, but the Treasury always allowed shorter lives than that on certain types of specialized machinery. I know some of my friends feel they have been a little niggardly at times and I don't agree that we have been allowing excessive service lives in general.

I think the factor of obsolescence is so important that physical wear and tear doesn't have too much to do with this any more.

Senator DOUGLAS. That is the next point I was coming to. How is obsolescence handled?

Mr. PATON. Senator, here is the way I conceive the problem. I think that possibly the statute is a little unfortunate in ——

Senator DOUGLAS. How does it handle the problem?

Mr. PATON. I have always conceived of the problem as the problem of the overall estimate of how long we are going to use the property as a result of all the factors that tend to make us some day retire it, and to me depreciation is simply a slice of the cost of the property that is writen off, or absorbed in a particular year, and——

Senator DOUGLAS. You would make it not merely physical, then, but physical wastage plus the relative efficiency, as compared to alternative uses of the same amount of capital?

Mr. PATON. Very much so. I would say that is the dominant thing.

Senator DOUGLAS. Physical wastage plus obsolescence?

Mr. PATON. Very much so.

Senator DOUGLAS. Do you think the Treasury has made adequate allowance for obsolescence?

Mr. PATON. I feel in the actual practice, particular decisions and particular determinations could be criticized, but it doesn't seem to me that in the overall we have been too bad on this question of service life. That is the impression I had.

Senator DOUGLAS. In other words, the service life arrived at by the Treasury has in general taken adequate account, both of the physical wastage of the capital asset and the obsolescence due to possibly greater efficiency from equal investments in capital in alternative machines or equipment?

Mr. PATON. It is my impression that it certainly has taken some account of the economic and other factors, as well as just physical wear and tear, as such, and I have had no personal complaint from my observation on that particular. You could pick out some particular class of property, Senator, that you could quibble about, but just in general.

Senator DOUGLAS. Now the next question I want to ask is addressed to whether physical depreciation shows itself in a gradual reduction of output or not. The first work that I ever read on depreciation—and I did not know it at the time that it was a work on depreciation—was the poem by Oliver Wendell Holmes on the Wonderful One Hoss Shay, which as you may remember, according to Holmes, ran for a hundred years with undiminished efficiency, only to fall completely apart at the end. In other words, it maintained 100-percent efficiency for 100 years and then fell off to nothing.

Do you regard that as an adequate description of the depreciation factor?

Mr. PATON. I often refer in my classes to the One Hoss Shay.

Senator DOUGLAS. This is not the Shays rebellion.

Mr. PATON. No, the One Hoss Shay theory of Holmes. The possibilities are these, when we spend our money for "plant," just using the term generally, the possibilities are that we might expense the whole doggoned thing right then and there. We might spread it during an estimated service life, or it might wait until the bitter end, and when it goes over the cliff, charge it to expense then. Now, of those various ideas, the last one is much the most unrealistic and unreasonable.

Senator DOUGLAS. I agree with you, as an accounting procedure, and I think this has been really one of the troubles in housing prior to FHA construction; namely, that the owners of residences did not take account of the depreciation of the building or rather expected the depreciation of the building to be made good by the appreciation of the real estate, so that when the building wore out, there was no fund ready to replace it, but that is an accounting problem and I think an extremely important one.

The question I was coming at is this: Is there a physically reduced capacity to produce as the machine or the tool or piece of equipment increases in age? Was it true that at the end of 99 years and 364 days the shay was as good as it was when it first came out from the stable?

Mr. PATON. That is unrealistic, on the physical side as well as on the economic side. Mr. Terborgh could tell you more about that than I could, but most equipment will not produce the physical output, leaving out all questions of value, in later as in earlier years. It is out of service more time for repairs, and so forth, so there is some decline.

An office building may have just about as much cubage in it in its last year as it might in its first, but its economic significance might be very different. Physical productivity, in my limited observation, does actually decline some with age.

Senator DOUGLAS. Does not?

Mr. PATON. It does decline with age, physical output, but it may not decline proportionately to what I would call the decline in the economic significance of the asset.

Senator DOUGLAS. Sometimes if you use the analogy of the machine with the man, the productivity declines more from 60 to 70 than it does from 30 to 40. If this were true for machines, it would lead to the exact opposite of the theory that Mr. Terborgh has been advancing.

Mr. PATON. During the tooling-up period of a month or two, a machine may improve, but as it ages, most machinery is out of service longer because of repairs and all that kind of thing.

Mr. TERBORGH. May I comment, Senator?

Senator DOUGLAS. Yes.

Mr. TERBORGH. It is an empirical fact that most equipment is used less intensively as it ages. That is not, however, primarily due to physical considerations. It is due to economic considerations. With increasing age, its services become higher-cost, hence, less valuable. They deteriorate both absolutely and relative to alternatives. For this reason the probable life history of a physical asset is one of diminishing-use intensity.

Senator DOUGLAS. Diminishing yield?

Mr. TERBORGH. Wherever use can be diminished, as it can in machine shops, for example. The reason for the diminishing-use intensity is not physical. It is economic.

Mr. PATON. It is partly physical because you have more repairs.

Mr. TERBORGH. The cost of repairs is an economic factor.

Mr. EISNER. I should like to throw out the point, Senator, that the physical usage or rate of physical usage, output of capacity associated with an asset, is really only 1 dimension that goes into the changing in value, and I think few of us, none of us, I am sure, believes that any property is like—or many properties are like—the one-horse shay, but we still have a situation that even with declining capacity, or uses, because of substitute goods, and so forth, the capital value may not decline at a larger increasing rate at first, and then a decreasing rate later.

Senator DOUGLAS. Each unit of physical output is assumed to be the same exchange value. In my questioning we assume there is no change in exchange-value relationships.

Mr. EISNER. Thinking of the capital value as the sum of discounted values to be received, the very process of discounting results in the lesser importance of the later returns, which are not going to be much, because of declining capacity.

Senator DOUGLAS. Then that means that this intensifies the diminishing yield. The decrease in yield is not merely a physical factor, but to a still greater extent it is an economic factor.

Mr. EISNER. Except curiously, for example, if you take the one-horse shay, where capacity is constant, the value declines quite slowly at first, because of this discount factor and it is only in the later years that you have a rapid decline in values, so in terms of the one-horse shay, straight-line depreciation is too rapid. Whether that is too rapid or not depends upon the rate at which the usefulness of the asset declines over time and rate of discount.

Senator DOUGLAS. Now if we may get back to this point. If there is a declining physical productivity and a declining value of productivity of a capital instrument over time, doesn't this raise some queries about the appropriateness of the depreciation ratio, as to whether the depreciation ratio conforms to the yield? I would like to raise a specific query—I have it written out and I will pass a copy down so that you can be studying it. I would like to address this question to the panel:

Assume that a machine has a 5-year life, a cost of $5, and a productivity of 5 units in the first year, but then declining physical productivity in successive years, and you can put this in terms of value if you want—4 in the second, 3 in the third, 2 in the fourth, and 1 in the fifth. That is the sum of years digits. Let us say that business buys 100 of these machines in the beginning of the first year, invests $500, and that it uses straight-line depreciation and reinvests in new machines an amount equal to its depreciation deduction each year.

In the first year it will have the output of 100 new machines at 5 units per year, and its depreciation deduction of $100, one-fifth for 500, will by 20 new machines. In the second year its output will be 100 from the second-year machines times 4, or 400, but plus 20 new machines, times 5, a total of 500, again.

If you carry through these calculations, you will find that output will stay at 500 a year, as long as the firm reinvests its depreciation deductions calculated on a straight-line basis, even though the productivity declines per machine as it ages. In view of this, is any faster writeoff justified?

Mr. TERBORGH. I don't think an answer can be given with specifications here. The proper rate of writeoff is a question of how the value of this set of assets moves over time.

The theory of depreciation is that if it is plowed back, as you suggest here, into the property, purchasing like assets, it will maintain the value originally invested in the account. What happens to the physical capacity is something quite different. For example, if I install 10 machines costing $1,000 each this year, take 10 percent straight-line depreciation on them, and devote this depreciation to buying more machines next year, and the year after, depreciating also the machines generated by prior depreciation, I will wind up eventually with 20 machines instead of the 10 I started with. By the theory of straight-line depreciation, their value will be the same as that of the original 10, because I started with new machines and wind up with twice as many machines averaging on the middle aged.

The function of the capital recovery charge in a going concern is to preserve the capital initially committed, to wasting assets. If it does

this the recovery is rapid enough. The real question is how fast to charge off or recover capital in order, by the reinvestment of the charge-off, to preserve it at its initial level.

There are only physical data given here from which it is impossible to deduce capital-value equivalents. Your example maintains the physical capacity that you originally started out with, but it would require additional specifications to determine whether depreciation by the straight-line method is adequate.

You cannot deduce the adequacy of the straight-line writeoff from the example merely because it preserves the physical capacity of the property. It might be necessary to expand the physical capacity substantially in order to protect the capital originally committed.

Senator DOUGLAS. I am not going into that question. I am merely dealing with the problem of depreciation and physical wastage itself.

The query is whether one would not be preserving the original capital assets by straight-line depreciation.

Mr. TERBORGH. The physical-wastage approach leads to the preservation of the physical capacity, but I can't accept that approach.

Senator DOUGLAS. We used dollar terms, but I mean dollars of constant purchasing power.

We have abstracted from changes in the price level, which presents a different problem that we would be willing to deal with, but we assumed that there was a constant value, that is, exchange value to each unit of physical goods.

If this decline is as we suggest a justification for a higher rate of depreciation in the earlier years, and some permanent net loss of revenue, it would have to be on other grounds than conforming to the actual facts of depreciation.

There may be those other grounds but I am trying to isolate them.

Mr. TERBORGH. The question is begged in my judgment, because the assumption is that the facts of depreciation are measured by what happens to physical capacity. That is quite contrary to my approach, which makes depreciation depend on what happens to the capital invested in the physical property. It is a device for conserving capital, not necessarily for conserving the original quantum of productive capacity.

Senator DOUGLAS. Mr. Brown?

Mr. BROWN. I think I agree with everything that Mr. Terborgh has said. There is one other factor that might be helpful here. Even if you were a dealer in, or a buyer of one-horse shays, and you just followed the retirement method of accounting—that is, no depreciation until you threw the asset away—if we entered into the process in the middle after the equipment had been set up then I think you would find that even the retirement accounting method would be able to maintain the physical plant, if you reinvested the amount that you charged for each year's depreciation. So I do not think this is a presumption pointing to any particular method. There are also a lot of complications that have been thrown in there that I would not want to deal with.

Mr. TERBORGH. Isn't it correct, Professor Brown, that the whole concept of retirement accounting is the preservation of a given quantum of physical capacity, and that the concept of depreciation accounting is the preservation of the capital committed to the property? They are incompatible.

Mr. Brown. Yes.

Mr. Eisner. I also agree with what Mr. Terborgh has said. I do think that the Senator has raised an interesting point in that he is destroying, I think by the example, a rather false issue which has frequently been raised and that is the statement that because of price inflation, and because of the concept of the relation of depreciation charges to losses in value, actually we are sort of wasting away and the depreciation charges if reinvested would not be adequate to keep up the capacity of the economy.

The two are quite unrelated. It is not at all demonstrated that depreciation charges are inadequate to keep up the capacity of the economy. There is of course a very serious question as to whether that should be a criterion of depreciation charges or rather change in value.

There has been so much I think rather emotionally written about just wasting away in the sense of not being able to keep up our capacity with depreciation charges, that this point is well taken.

Senator Douglas. This gets into the problem of changing price levels, and therefore I hand down the second question.

We financed World War II to an important extent by inflation.

That is, by a policy of reducing the purchasing power of people's money claims. Consider an asset earned prior to World War II, consider that an asset earned prior to World War II would not recover its depreciation cost plus a fair return, if all of the prices connected with this machine and its product doubled after the war, it follows the machine is now earning enough to recover its replacement cost plus a fair return.

Is it not accurate to say that the owner of this asset avoided the burden of inflation, since the physical product in money terms is yielding twice as much as before?

Is there any reason why he should be tax free on the measure of this, namely, the difference between the original and replacement cost of depreciation, or put another way, the advocate of replacement cost depreciation seems to say, "I want to be tax free on enough income to restore my prewar status."

Is not this asking too much?

In order to make the wartime supply of goods cover the supply of money, purchasing power of money was reduced and the status quo is permanently lost.

I might say I would much prefer to have had the war financed by taxation in much larger degree than it was done, to a much smaller degree by inflation, but the war was financed indirectly, about 57 percent I guess, through inflation.

I wonder if the members of the panel have any comment on this.

Dr. Paton, you are the replacement cost man.

Mr. Paton. Well, I might comment on it briefly. The impact of the inflation on various groups in the community has varied undoubtedly, and some may even have conceivably prospered as a result of it, although I am inclined to think that most of us have not, especially schoolteachers, but I would say that with respect to depreciation accounting, we have an actual problem of measurement, in addition to the question of what tax rate should be, and so forth, and I would insist that someone who is heavily loaded with property acquired in

the prewar years is not being permitted to deduct his actual cost of property in the only meaningful sense, namely, the purchasing power sense, when we tell him that one 1955 dollar of revenue is equal to one 1940 dollar of cost consumed.

Now what we should do with his net income after he gets it, what tax rates he should pay and all that is another question, but as a matter of measurement, his earnings are being overstated when his depreciation is not converted into the current dollars which appear throughout the rest of his income statement; and moreover there are important industries in the country such as the public utilities for example that are very heavily loaded with prewar acquired assets, whose prices have not gone up like the prices of the industrial companies by and large, who have adjusted themselves to this fairly well, but some of the other companies, whose prices are subject to various restrictions and controls, have not.

Now, Senator, my main point would be that we ought to distinguish between accurate measurement in dealing with particular groups or individuals, and the question as to whether we have got to interfere with the impact of inflation on various groups.

The bondholder obviously is one of the worst treated, the bondholder in general is one of the worst treated, and there is inaccurate measurement in that area also.

My main point, I do not know if your question was directed particularly to the remarks I made in my main piece by my main point is that of measurement.

I object to our accountants going blithely along and assuming in all of this area that the various generations of dollars are the same thing.

Senator DOUGLAS. From the standpoint of the measurement of real capital growth I quite agree with you and when I was a practicing economist many years ago and tried to measure the physical growth of capital in the country I was very careful not to take dollar terms of capital but I tried to measure the replacement of physical units at given price levels to get a figure, an approximate figure at least, of the growth of physical capital.

Mr. PATON. Using common dollars?

Senator DOUGLAS. What I am trying to say is if you go into tax policy you have got to consider the situation as a whole and not merely the accounting for any one particular class.

Is it not true that the possessors of the instruments of production had a hedge against inflation which other groups did not have, because the products jointly turned out by labor and these instruments of production also rose in price, and hence gave more money income, and therefore furnished a protection against the loss of money value of the physical asset itself under these accounting procedures?

In other words, this is a class which was protected far more than the recipients of interest or fixed incomes such as people on pensions, and so forth, and if you were going to say that all losses suffered during the war are to be retroactively made good, then I think we would have to recapture some of the economic gains made through inflation during the war—and there were such, there is no doubt about that—and redistribute amongst those who had suffered greater losses.

I wonder if you did not take a somewhat restrictive point of view, therefore, in discussing tax policy.

Mr. PATON. I would like to make just one comment on that.

I think anybody would be foolish to propose unscrambling the eggs in general, or attempting to restore equity here or equity there as a result of the inflation situation.

We cannot do it in the case of Government bonds obviously and there is one of the serious cases.

Nevertheless, I think that as you stand in any one point, Senator, and are considering where you are going from there, and what constitutes good policy and all that, that it is extremely important to get your measurements in order.

Also I want to state once more that there are certain important areas which happen to be very heavily loaded with capital goods, where prices have not been permitted to rise, so that correct measurement there might be of special importance if you for any reason wanted to avoid a higher tax rate there than the normal rates; but I agree heartily that we just cannot—we have got too many problems to solve—to set about restoring the status of any class or group.

Senator DOUGLAS. I am glad you do not want to rewrite the depreciation sections of existing tax law then along the lines that I thought you were suggesting in your paper.

Mr. PATON. I would like to make some changes.

Senator DOUGLAS. That is all, Mr. Chairman.

Mr. MILLS. Are there any other questions?

Are there any suggestions, further suggestions, from the panel?

If not, on behalf of the subcommittee let me thank each of you for your appearance and the contribution you have made to our study both in the compendium and in your appearance here this morning.

We appreciate it very much.

The subcommittee will adjourn until 2 o'clock.

(Whereupon, at 12: 55 p. m., the subcommittee was adjourned, to reconvene at 2 p. m. the same day.)

AFTERNOON SESSION

The subcommittee met at 2 p. m., the Honorable Wilbur D. Mills (chairman of the subcommittee) presiding.

Present: Senators Paul H. Douglas and Barry Goldwater, and Representative Thomas B. Curtis.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The subcommittee will come to order, please.

This afternoon's session of the subcommittee on tax policy will be devoted to discussion on the role of commodity taxation in tax policy for steady growth.

As was announced this morning, our procedure is to hear from the panelists in the order in which their papers appear in the compendium Federal Tax Policy for Economic Growth and Stability.

At the start of each of these sessions, panelists will be given 5 minutes each to summarize their papers. We will hear from all panelists without interruption. The 5-minute rule will be adhered to and I have asked the staff to raise a card when the speaker has spoken 5 minutes.

Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session. I hope that this part of the session can be informal and that all members of the panel

will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee's questions.

Our first panelist this afternoon is Prof. John F. Due of the University of Illinois.

Professor Due?

Mr. DUE. Mr. Chairman, I will summarize my paper which is entitled "The Economics of Commodity Taxation and the Present Excise Tax System."

The basic philosophy of commodity taxation is that of distributing a portion of the total tax burden in relation to consumer expenditures, either on all commodities, as in the case of general sales taxes, or on certain commodities, as in the case of excises. This philosophy is realized to the extent to which the taxes are shifted forward to the consumers of the products. Such shifting is probably by no means exact or complete, and a portion of the taxes without question rests upon the owners of business firms, or is shifted backward to other factor owners.

To the extent to which the present excise taxes are shifted forward in higher prices, households must curtail savings or consumption expenditures; they are likely to do each in part. Consumption curtailment will primarily affect the taxed commodities if the demand for them is elastic, and other commodities if it is inelastic. Unlike other taxes, the excises give definite incentive to shift consumption from taxed goods to others. In addition to their effects upon consumers, the excises will tend to lower business profits, in cases in which complete shifting is impossible, or sales volume is significantly affected by the price increase. Excises which impinge upon certain methods of production will encourage firms to use other methods, with consequent loss in efficiency in the use of resources.

As contrasted to income taxes yielding the same revenue, the excise taxes probably cause a somewhat greater curtailment in consumption, although the difference may be less than is commonly assumed, since such a large portion of income-tax revenue comes from the lowest tax bracket. The income tax does not provide a definite incentive to alter consumption patterns, as do the excises. The excises probably produce less adverse effect upon incentives to undertake business expansion than do higher-bracket income taxes, but the indirect effect upon investment arising out of curtailment of consumption may be greater in the case of the excises.

Of the present excise taxes, two groups of the taxes find greatest justification. These are (1) the traditional sumptuary excises on liquor and tobacco, which reflect the widely accepted philosophy that users of such products can justifiably be made to pay a tax penalty, and (2) the taxes on gasoline, motor vehicles, and allied products, which can be justified as means of financing Federal highway programs on a benefit basis. Against the other excises, the primary objections include (1) the shifting of consumption from taxed to untaxed goods which inevitably results, (2) the discrimination against persons having relatively high preferences for the taxed articles, (3) the discrimination against the owners of business firms adversely affected by these taxes, (4) the incentive given by a few of the taxes, especially that on freight to alter methods of production, with consequent loss of efficiency in the economy, and (5) should a depression

develop, the probable greater deflationary effect, per dollar of revenue, than that produced by other taxes.

Replacement of the luxury excises by a general sales tax would lessen the discrimination against particular consumers and the altering of consumption patterns and lessen discrimination against business firms. Some discrimination would remain because of greater ease of tax shifting in some fields than in others. However, introduction of a sales tax would increase the regressiveness of the Federal tax system and discrimination against large families, involve Federal entrance into the field which is the chief source of State tax revenue, and increase the deflationary effect of the tax structure in case of depression. Certain administrative problems would be difficult to resolve.

The preferable alternative to the introduction of a Federal sales tax is modification of the excise-tax system to lessen the adverse effects of the system. The following modifications are suggested:

1. Complete elimination of the tax on freight, a levy which has no justification on any logical basis, and tends to encourage shipment of goods by firms in their own vehicles, to the detriment of the development of an efficient public-transportation system.
2. Elimination of the tax on passenger travel, which, by giving an artificial tax advantage to travel by car, adds to the ever-growing problem of highway congestion.
3. Reduction in other luxury excises at least comparable to reductions made in income taxes. The objections to luxury excise taxation are such that it is impossible to justify a policy of reducing income taxes while excises are left unchanged; a better case could be made for the opposite policy.
4. Retention of the liquor and tobacco excises, as well as those on gasoline, motor vehicles, and related articles.

Mr. MILLS. Our next panelist this afternoon is Prof. Harley L. Lutz, Princeton University. Mr. Lutz.

Mr. LUTZ. Mr. Chairman and gentlemen of the subcommittee; the subject of excess taxation is so controversial that I thought it best to lay a foundation for the approach which I propose to make to that subject.

First, all taxes are paid out of income, either as it is received or as it is spent. This means that even the taxes levied on business are eventually borne by persons.

Second, taxes should be levied only for the support of Government. When this standard is forsaken, the evils of discrimination, inequity, interference with economic decisions, and restriction of economic growth emerge, because no one can be wise enough to determine, at each step, what the best next step for the whole economy should be.

Third, taxation for revenue only should assume a neutral effect of taxes, a goal which is best attained under proportional tax rates.

Fourth, uniform or proportional taxation requires a broad tax base. The broadest possible tax base is the income of the people, and all of this income can be reached only by placing part of the taxload on income as it is spent instead of concentrating all of it on a narrowly defined concept of income as received which is known as "taxable income."

Fifth, taxes on income as it is spent are commonly known as excise, or consumption taxes. There is no defense of the miscellany of excises

now imposed by the Federal Government, but a properly designed excise has many characteristics of a good tax, viz:

(*a*) They are a perfect example of installment payment, and of current tax payment; (*b*) administrative costs are low; (*c*) they involve no forms, no reports by the individual consumers, no audit of taxes paid, and no back tax; (*d*) they permit taxpayers some discretion as to the amount of tax and the time of its payment; (*e*) they are not subject to manipulation through "gadgeteering."

Sixth, consistency would require universal application of the tax to all goods, or to all services if the latter class is to be included. Practical considerations warrant separate tax treatment of alcoholic beverages and tobacco, based on long historical experience; and also for the exemption of food products as being the one commodity which would provide general rather than discriminatory exemption treatment for all persons.

Seventh, the selection of the point of levy—retail, wholesale, or final manufacture—involves consideration of arguments on both sides. Some matters would be more troublesome and others less so, according to the point of imposition. The writer's conclusion is that, on balance, the case is strongest for the manufacturers' excise, although it is possible that the wholesale level would be equally admissable. A Federal retail excise or sales tax should be avoided, both for administrative reasons and to avoid direct duplication of, and conflict with, the sales taxes now collected in some 32 States. Even if the manufacturers' excise were to involve some additional administrative difficulties—which is not conceded here—it would be better policy to endure these than to encroach upon a source of State—and local—revenue which has attained so great importance. The outcome could well be an increase of Federal grants, a result which would be serious for the fiscal independence of the States.

Eighth, the conventional criticisms of excise taxes in general are (*a*) reduction of spending power and (*b*) regression in relation to income. Any tax reduces the income available for spending by the taxpayer, but it does not diminish total spending power in the economy because the Government spends the money taken from the people.

The efforts to establish regression in recent discussions have dealt with the overall taxload rather than with excises per se. The results depend on the assumptions used, and at best establish no regression or so little as to provide no case for elimination of excises. None of these studies have dealt with the disastrous consequences of substituting more and heavier taxation of incomes for excises.

Nine, the objection of pyramiding applies only to excises imposed elsewhere than at the retail level. The inclusion of necessary added costs in the prices to consumers is proper, but this is not pyramiding. In a field of business as intensely competitive as the distribution of goods and services, profits depend on supplying customers with what they want, and when and where they want it. There would be no extra profit in the mere relay of a tax. The growth of discount business reveals the weakness of the oldtime rigid percentage markups, and the existence of fair-trade legislation indicates the weaknesses of the contention that these markups are a necessary "built-in" feature of modern retailing.

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Tenth, a manufacturers' excise, levied across the board on all end products of manufacture except alcoholic beverages, tobacco, and feed products, in substitution for the present discriminatory hodgepodge of excises, would be the soundest solution of the Federal excise-tax problem.

Mr. MILLS. Our next panelist is Mr. E. C. Stephenson, vice president, the J. L. Hudson Co., Detroit, Mich.

Mr. Stephenson.

Mr. STEPHENSON. Consumption taxes, and I am addressing myself to this question of end product of manufacture, will have the effect of building substantially higher costs of producing the product purchased by the ultimate consumer, in addition to the tax specifically imposed on the product.

The words "end product of manufacture" have very serious implications when the entire pricing structure through the processes of manufacture, wholesaling and ultimate sale to the final consumer is understood.

They mean that the tax would be imposed on the sales price at the manufacturers' level, on the brick, stone, plaster, steel, plumbing, heating, electric wiring, electric equipment and all other components required to construct any manufacturing plant. If such materials are acquired through a middleman there would undoubtedly be a profit taken on the tax to reimburse the middleman for added ad valorem taxes, insurance and other costs occasioned because of the excise tax.

Production machinery and tools, all office furniture and equipment, all machine parts and maintenance supplies and all other supplies of whatever character, will be increased in cost at least to the extent of the tax, and probably more, depending on whether the article is secured through a distributor.

The manufacturer will pay higher ad valorem taxes on plant machinery, equipment and supplies, and higher insurance costs on these more costly facilities.

He must recover all these added costs of depreciation, repairs, taxes, insurance and other items of expense by means of an increased sales price for his product, to which must be added the excise tax if the product does not fall within one of the excluded classifications.

It will be argued that competition will prevent the price increase outlined here, but all manufacturers will be faced with similar increased costs of production, and will employ similar methods to save themselves from loss of profits, to the maximum extent possible.

The wholesaler is faced with similar problems. His plant, equipment and consumption materials will increase in cost. Higher ad valorem taxes on plant, equipment, and supplies and on an increased cost of inventory, higher insurance costs on all these items, increased depreciation costs and higher costs for repairs and supplies, must be recovered by means of an increased sales price if the wholesaler is to remain in business.

The retailer, the last step in the chain of production and distribution, faces the most serious problems of all. His plant, fixtures, equipment, and consumption materials will increase in cost. Ad valorem taxes and insurance costs on plant, equipment, and supplies will increase, depreciation charges will be larger, and higher costs for repairs and supplies must be recovered from the sales price of merchandise.

In addition to these increased costs, the merchant is faced with increased ad valorem taxes on an inventory increased in cost to him because of higher cost of manufacture; the excise tax; higher wholesalers' operating costs; increased insurance costs on this increased cost of the inventory; greater working capital requirements and therefore higher interest costs to finance inventory investment; substantially higher rental costs based on a percentage of higher sales prices; higher compensation to salespeople based on a percentage of a higher sales price; greater hazards of loss in the value of merchandise inventories in time of declining prices because of an excise tax paid for at the time of the purchase of his inventory. Falling prices would not bring any reduction in the tax cost of existing inventories because that tax was paid when the merchandise was purchased.

As has been demonstrated here, the real meaning of taxing the "end products" of manufacture is to build into each step of the cost of producing and the cost of distributing articles for consumption, a series of increased costs for depreciation, maintenance, repairs, taxes, insurance, interest, rentals, compensation to sales personnel, and hazards of loss on unseasonable merchandise and merchandise declining in value because of market conditions. All of these added costs, plus the profit margins on cost taken by the entrepreneur in each step of the process of production and distribution, increase the price to the ultimate consumer much more than the amount of the tax collected and paid to the Government.

2. These costs will pyramid in the price the consumer must pay.

3. The consumer's ability to buy will be lessened because of higher prices, the standard of living will be lowered.

4. The burden of consumption taxation will fall largely on the 42,201,664 taxpaying units reporting incomes of less than $10,000; plus the 7,500,000 individuals receiving social security payments; plus those living on interest, dividends, wages, and other income in insufficient amounts to be subject to income taxes.

5. All of the people enumerated in 4 above will lose the right of choice to the extent of the tax-caused increase in price paid, as to how their income shall be spent.

6. While it is unquestionably true that all corporations would like to accelerate the speed of capital formation, and increase dividend payments, the available evidence shows that a truly remarkable growth has occurred in stockholders equity. The evidence does not indicate the corporate and individual income taxes have destroyed capital at its source. The evidence indicates that capital growth in the next decade will be far greater than in the past decade. If conditions permit reductions in either or both corporate and individual income tax rates, future growth of capital should satisfy the most impatient of the Nation's entrepreneurs.

On the basis of this evidence, it seems highly questionable to substitute a system of consumption taxes for a lowering of income-tax rates on corporations and higher paid individuals.

7. While it is true that all tax revenue enters the stream of spending, that spending does not necessarily benefit the low-income consumers. I do not believe that excise taxes in America could or would ever reach the drastic extremes they have reached in Russia. However, recent press releases report that England has hiked excise taxes 20 percent to reduce consumption.

The Russian situation, however, where hidden consumption taxes range from 15 percent to 88 percent of the retail prices, shows clearly how such taxation has deteriorated the standard of living of the ordinary Russian citizen and robbed him of the right to use his income to meet the requirements of living for himself and family. The funds raised by this taxation are used to build a huge war potential. They do nothing to improve the lot of those who are taxed and who have no voice in the spending.

8. Consumption taxes are inflationary. They will increase the cost of living—increase the BLS cost of living index, influence wage rates and increase parity prices for agricultural products.

9. The American labor force is growing rapidly. More efficient production machinery (automation) and improved methods are constantly increasing the productivity of labor. The growing labor force, producing at a constantly improving production per man, must be kept gainfully employed.

10. The only answer to America's ability to produce is the ability to consume the products produced. The genius of our engineers and managers to produce an ever-increasing flow of goods per man-day with an ever-increasing labor force will be of little importance if the American citizen, individually and collectively, is unable to consume these products. Limiting the ability to buy by tax-created higher prices is not the answer to our problem.

Business in our free-enterprise economy always produces a series of chain reactions. If the customer buying for personal consumption cannot or will not buy, the producer does not manufacture, employment declines in all the processes of production and distribution of both capital and consumer goods, lower profits are earned—less wages will be paid, governmental revenues will decline—everyone will suffer. If we look back to the thirties, particularly the early thirties, we will be able to see the effect on the entire economy resulting from a drying up of the ability to buy, of the consumer purchasing for personal consumption.

11. The present discriminatory selective excises should be repealed at the earliest possible time—I am not including in the word "excises" the liquor and tobacco taxes, certain taxes on stock transfers, transfer of properties, and so forth, should be repealed—and that repeal should end any further consideration of broadening the base for excise taxes in the Federal tax structure.

Mr. MILLS. Our next witness is Mr. A. W. Zelomek, president, International Statistical Bureau, New York City. Mr. Zelomek.

Mr. ZELOMEK. Mr. Chairman, members of the subcommittee, many faults can be found with the present excise-tax structure.

Some of the faults lie in the fact that most of the present excise taxes were passed during an emergency, when there was no particular need for Congress to feel concern about their effects. And, although the emergency is long since over, excise taxes as a whole are still treated as if a flat rate can reasonably be applied to all the different commodities and services subject to these taxes.

This illustrates an even more basic fault. Different commodities and services very seldom have the same elasticity of demand, and a 5-percent tax on one commodity may have more of an effect on its sale to consumers than a 15-percent tax on another commodity. If excise taxes are to be used at all, there should be a clear understanding

of the impact that different rates will have on different commodities. Unless a scale of individual rates is maintained which will have the same general effect on the demand for the individual commodities and services to which they apply, some commodities are bound to be penalized unduly. It is one thing to have such a penalty as an intention, and quite another to have it occur accidentally, in an excise-tax structure which is intended to extend equal treatment to all commodities and services to which it applies.

The 20-percent tax on establishments which serve food and beverages, and which either provide entertainment for their patrons or allow their patrons to dance, illustrates many of the difficulties and inequities encountered under an excise-tax structure. A case study of this particular tax was conducted under the auspices of the American Federation of Musicians, through the field facilities of the Research Company of America, with results subjected to economic analysis by the writer and his associate, Dr. Robert C. Shook, leads to the following conclusions:

1. Establishments subject to this 20-percent tax provide almost as much employment for musicians as all other sources of musical activity.

2. Since 1943, the last full year before this tax was raised to an emergency rate of 20 percent, job opportunities for musicians in establishments subject to this tax have declined by at least 55 percent.

3. This tax provides a revenue which has decreased from approximately $71 million in 1946 to a little less than $39 million in 1954. Complete elimination of the tax would lead to much higher business income-tax payments, particularly by the small establishments which provide dancing or entertainment for their patrons. The gross loss in revenue, if this tax is eliminated, would be less than $5 million a year, counting only the increase in income-tax payments by the establishments themselves. This represents a gross loss, with no allowance for the administrative and enforcement expenses connected with this particular tax.

4. Upon elimination of the tax, these establishments would immediately make greater use of their entertainment and dancing facilities, in which their proprietors have an investment. There would quickly be an increase in hours of employment for musicians already working in these establishments of almost 70 percent. Most proprietors state that they would also increase the number of musicians employed, in order to improve their competitive position.

5. Counting only the increased income-tax payment of musicians, and only of those musicians who would immediately have an opportunity to work longer hours, the total increase in income-tax revenue to the Federal Government, if this tax is repealed, would exceed the revenue lost from the excise tax itself. This makes no allowance for increased income-tax payments by entertainers, or by waiters, waitresses, or kitchen and other service help.

In our consideration of tax policy and its effects on long-term economic growth, we must consider more than plant and equipment and more than the purchasing power that will be available for material consumers' goods. The writer agrees with the statements made by Alvin H. Hansen, of Harvard University, in his comments on economic stability and growth before this committee.

* * * We place too much stress on brick, mortar, and machines when we plan for long-term growth. * * * Have we not by now reached in the United States a degree of plenty with respect to the physical necessities which would permit greater attention to education, health, recreation, and the necessary, varied range of cultural activity in general? * * * 20 years hence * * * a larger proportion of our population should be teachers, doctors, musicians, actors, artists, and leaders in recreational, youth, and community activities.

It can be stated without much doubt that we will not have more musicians 20 years hence, if excise-tax policy continues to penalize the establishments which provide almost half their present employment. Membership in the American Federation of Musicians has increased from 134,000 in 1940 to 252,000 in 1954. But in 1940 some 76,000 musicians managed to put in about 80 percent of full time at instrumental activities, while in 1954, 83,000 musicians could only find work at their specialty representing 56 percent of a full-time effort.

In 1940, 26,000 musicians did some playing, enough to represent about 35 percent of a full-time effort. By 1954 the number of part-time instrumentalists had increased to 42,000, and their instrumental activities represented only about 28 percent of a full-time effort. More shocking still, in 1954 there were 88,000 musicians, representing 35 percent of the entire membership, who had given up entirely the occupation for which they were trained and talented, and who were depending for their livelihoods entirely on nonmusical activities.

Musicians had been affected by technological changes even before the emergency tax of 20 percent was placed in 1944 on establishments providing almost half their employment. The depressed condition of musicians today is not the fault of the public and does not show any lack of interest in live music. More musicians are employed today in symphonies, in opera and ballet, and in theatrical presentation than ever before. But these gains have been small in comparison with the losses in job opportunities.

In 1929, for example, the equivalent of approximately 100,000 full-time jobs was available to musicians. Since then, although the economy has expanded substantially and most occupational groups find themselves better off than ever before in history, job opportunities for musicians have shrunk to the equivalent of 60,000 full-time jobs.

Music is a major element of the Nation's cultural life, and to have music we must have musicians. To have fine music, we must have fine musicians. And to have fine musicians, we must have an economic breeding ground for musicians of all kinds.

The musician holds the same relation to the Nation's cultural health as the farmer holds to the Nation's economic health. When the farmer was depressed by economic changes, the Nation, through the Federal Government, gave him help, and still does. But in a period during which the musician has been depressed by technological changes, his economic position has been further impaired by the 20 percent tax on music, dancing, and entertainment.

Mr. Mills. We thank each and every one of you for the splendid summaries of your presentations appearing in the compendium.

I will ask Senator Goldwater to begin the interrogation this afternoon.

Senator Goldwater. Mr. Chairman, I don't think there can be too much interrogation, because the panel finds itself in fairly substantial

agreement on the general premise that the excise tax does more harm than good.

Mr. LUTZ. No.

Senator GOLDWATER. Professor Lutz has suggested a substitute. I think he agrees that the excise tax that we collect today is a restraint on business and, in fact, his opening remarks says "The taxes should be levied only for the support of Government," and I am in hearty accord with that. He goes on to say:

> Any tax reduces the income available for spending by the taxpayer but it does not diminish total spending power in the economy because the Government spends the money taken from the people.

I think my original remark is fairly accurate and I will be open to argument on it.

We are in disagreement, though, and we can say this throughout the retail industry, and also in the wholesale industry, we are in disagreement as to how to substitute for the incomes that would be lost if the excise taxes were done away with in any substantial way.

I like the paper by Mr. Zelomek and by Mr. Stephenson, who both point out that we have long since reached the point of diminishing returns in this form of taxation.

The example of the musicians, where Mr. Zelomek points out on page 605 of his paper, that 53 percent more would be employed if this 20-percent tax were removed is a good point. He further argues, and I think rightly, that the income from these reemployed musicians, plus the income taxes from the establishments hiring them would more than make up the revenue loss.

I think any study would show that the same situation existed in the fur industry to a substantial degree, that the same situation exists in the jewelry industry to a substantial degree, that we can find many industries in America that actually have been injured by the excise tax at the retail level.

There is one suggestion that hasn't been made.

I sit here day after day, hoping that somebody would come up with it, but evidently as I said the first day, it is so old-fashioned that we shouldn't even talk about it anymore.

Now, Mr. Stephenson, in your business and mine, if we can't afford something in our budget we eliminate it.

Mr. STEPHENSON. That is correct.

Senator GOLDWATER. What would be wrong if the Federal Government sees no way of raising more money through taxation of having the Federal Government balance its budget and go merrily on our way in that old-fashioned idea?

Mr. STEPHENSON. Is that a question directed to me?

Senator GOLDWATER. Yes.

Mr. STEPHENSON. Perhaps I am old-fashioned, too, Senator, but I always relate governmental spending to what I do in my home, in my family affairs. If we can't have something we don't buy it, and it seems to me that the Federal Government could very well consider many of the recommendations made by the Hoover report, and could find ways to reduce the need for some of our tax revenues, rather than searching for new ways to secure more tax revenues.

My own feeling is that if we ever opened up this Pandora Box of broad-based excise taxes, that we really will be in for a lot of manipulations for many reasons.

I think that if we can't cut our costs today, we will never have an opportunity to—if we can't do something now to reduce our Federal debt and cut our interest cost, we will never have an opportunity to.

As Mr. Zelomek pointed out this is the year in which we are probably having the highest income, highest business activity, the most disposable income the country has ever known. This is our opportunity to cut costs of government by debt reduction. Thank you.

Senator GOLDWATER. I would like to get to Dr. Lutz in particular because I still maintain we are basically in agreement.

On page 2 of your paper, Doctor, you said:

> There is no defense of miscellany of excises now imposed by the Federal Government, but a properly designed excise has many characteristics of a good tax.

I don't think many people can argue that point, certainly, as the State sales tax has proven. However, you make statements in here, one statement in particular comes to my eye, under (b) that: "administrative costs are low." That is true in the case of the governing agent or the taxing body, but it is not true for the person who is collecting that tax.

What the State government has done, and what the Federal Government has done, is to transfer the responsibility of the collection of taxes to the retailer, and now you suggest that it might be transferred to the wholesaler. That is a very, very large cost, and it contributes in a sizable way to the cost of merchandise sold at either level.

Have you given that thought?

Mr. LUTZ. Senator, suppose we consider the cost of collecting income tax. That cost is not borne by the Treasury, either. It involves a very substantial accounting burden to every employer who has any large number of employees.

I would suggest that in the case of the general excise tax, of which we are speaking, the total administrative cost will be less at the manufacturing level because there will be fewer persons with whom the Government has to deal than there would be if a similar amount of money were collected at the retail level, or I suspect even at the wholesale level.

I haven't any figures as to administrative costs, either for the State retail sales taxes or for the cost of collecting the present $9 billion or $10 billion of excise taxes which the Federal Government does now collect.

As a matter of fact, it collects a very large part of those at the point of final manufacture as you know, so that if we could get from the Treasury Department some adequate information as to the allocation of costs to the collection of these I suspect we would find they were reasonably in line with the administrative costs of any other part of the taxes system.

We are in agreement as to the unsoundness of the present Federal excise system and if that is what your initial statement intended to convey there can be no argument between us.

Could I raise a question, however, about the balanced budget?

Senator GOLDWATER. Before you get off that one point, since I have to leave, I did want to get this thought from you.

In your point 9, you infer that the inclusion of necessary added cost in the prices to consumer is proper but this is not pyramiding.

Whenever you increase the cost to the whole area at the manufacturing level it pyramids right up to all ends. I don't see how you can define that.

Mr. LUTZ. I define pyramiding in the paper which I submitted for the compendium as a multiplication of the profits by reason of adding markup to the tax, and expressly excluded from my definition of pyramiding any necessary costs that are added.

Now, if you as a retailer have your local property taxes increased, because of a higher assessment or higher tax rate, those costs come in finally and have to be represented in the price that you get from the merchandise.

Then if there is another general round of wage increases, that, again, goes into the costs, and if the definition of pyramiding as I have used it is correct it would mean that retailers and wholesalers would make more profit with every increase in wages, because that enlarges the base cost on which they make their markup. And I would say that any cost for insurance, for interest on additional financing to carry a given inventory, or anything else of that sort which is involved on the assumption that you have a tax, say, at the manufacturers' level—those are just as proper and necessary additions to the cost of the merchandise as would be any addition to cost resulting from an increase of the wages you pay in your own store, or an increase of wages at the manufacturing level which, again, enlarges the price that you have to pay for the merchandise. Such items would also increase your financing costs, your insurance costs, and all of the other sources of increased cost that Mr. Stephenson has mentioned.

I don't see how we can avoid the proposition that any increase in costs, whether it comes from wage increases or tax increases of other sorts, or the addition of an excise tax, must go along to the consumer.

All I am questioning in that argument is that there is no chance in as highly competitive business as distribution, whether at the wholesale or the retail level—there is no chance for any of these people who are merely relaying a tax along to the consumer to take a markup on the tax and make more money.

Now, if he could do that why does he wait for the excise tax? He could do it now if that were a way to larger profits.

I don't believe that under the competitive situation we have in distribution in this country there would be very many people picking up some extra easy profit by reason of the fact that the tax was there.

Senator GOLDWATER. No.

I think we are at a little variance on our interpretation of pyramiding. The fact is, as labor costs go up and as costs increase, the man in the field of distribution at all levels has found his percentage of profit decreasing year by year. You know as well as I do that they are at the lowest level in their history today, but what I am afraid of is this, and I haven't had my mind satisfied on this yet, the manufactured merchandise represents many basic manufacturers, who would begin at the bottom and pay the tax, say on the manufactured piece goods, on the manufactured button, on the manufactured thread, in the case of a man's shirt or a lady's dress.

Those would come up to the manufacturer of the particular item, with the excise tax on. Then the excise tax would be put on the manufactured goods. The resulting price to the distributor or to the retailer, if he deals direct, would have to represent the increase caused

by the increase on excise tax, or the excise taxes themselves. That would result in a higher price to the consumer—not that there is going to be any more profit made because there will be less profit made in the long run because they will have to pay administrative costs of collecting it down at the bottom or the middle, but you get the higher price on the commodity to the customer, and what Mr. Stephenson has been trying to bring out, and what Mr. Zelomek has been trying to bring out is that if we can keep these resulting costs to the consumer down, the consumer is going to spend more money and we will have more taxes coming in in the long run—I believe that theory is correct.

Mr. LUTZ. But, Senator, we apparently have two different conceptions of how this tax which I have suggested here would operate. I would have no thought of imposing that tax on anything that became a component of further manufacturing. Now, if the finished dress is the end product of that particular process, piece goods that are going into dresses, thread, buttons, furnishings of every sort that are going into the manufacture of dresses would not be subject to a tax.

The tax would only come on the final factory cost of the finished article for consumption.

Now, it is true that if you have a piece-goods manufacturer who is selling a part of his product to a dress manufacturer, and another part to be sold to women who want to make their own dresses, you have the same situation that you have in Canada, where a constructive price would have to be determined for the article which itself becomes an end product in the sense that it goes directly to a consumer and a tax paid there, but it would not be imposed upon those parts of these various products which are eventually assembled into a final finished product.

Senator GOLDWATER. I am afraid we would be building some beautiful loopholes in our tax law because it is pretty difficult to imagine anything today that goes into an end product that doesn't also find its own way into the channels of trade. I have tried to conceive of instances of that, and they are mighty few. I am afraid your tax when we got all through arguing about it would have to go on all manufacturers, because there you get again into the problem of trying to exempt this one or part of this one and not exempt the other part, exempt this one entirely, and you would run into pretty much the same situation we find today in our whole tax structure where it is filled with loopholes and filled with inequities.

Mr. LUTZ. I doubt if you would have the kind of problem that you are suggesting there, because it seems to be a fairly simple administrative matter to apportion the part of a piece-goods manufacturer's product, which he sold to a dress manufacturer, and the part which he sold as piece goods in the wholesale or retail trade for purchase by women who are going to make their own dresses.

Senator GOLDWATER. I can see a beautiful loophole there. I could drive a truck through it.

Mr. LUTZ. That would not make it much different from a lot of other things in our tax law.

Senator GOLDWATER. I agree with you on that. I believe we should lend our interest toward the elimination of those.

Mr. STEPHENSON. While it is true, as Mr. Lutz has pointed out, that the proposed Mason bill, which has been offered twice I believe,

does not tax a commodity which is going into further production, the tools and equipment, the plant, and all those things which are necessary to the manufacturer will have to carry the tax.

In fact, the Mason bill goes so far as to define that if a manufacturer produces a tool for his own use, that he shall pay a tax on the imputed value of that production tool, and therefore it is true that the tax will not be imposed on, we will say, the piece of material that is going to go further into dress manufacture, the sewing machines, or the weaving machines, and all that sort of thing which made that piece of material would be taxed and part of that cost would have to enter into the cost of that product.

Mr. LUTZ. Mr. Chairman, could I comment on that?

I am not here proposing to make a case necessarily for the Mason bill or for any other specific piece of legislation as may have been suggested, but I think you are confusing the impact of a tax on a machine.

Let's say that we will consider that a sewing machine is an end product of manufacture and is to be subject to tax.

You have a piece of equipment there which has 10 years of life, 15 years of life. It will make millions of stitches before its useful life is ended, and by the time you spread the 4- or 5-percent tax on the factory cost of that machine over all of the stitches that are run through that sewing machine before it is discarded as obsolete, I do not think you can find the apportionment of the tax in any particular dress or stitch that the machine happens to make.

Senator GOLDWATER. I do not think that machine costs, capital costs, would increase to any appreciable extent on a tax such as you suggest.

Mr. LUTZ. I do not think so either.

Senator GOLDWATER. In fact, the only major increase would be in the cost of the goods that are needed in its manufacture.

I maintain that in the long run, it is going to cost more to administer that tax, and it is going to cost the American people more.

Mr. LUTZ. Insofar as there are additional costs, and bear in mind that there are costs of administration of any tax that you might devise, borne partly by the Government and partly those who have to comply with the regulations of that particular tax, I do not believe myself, at least I have no evidence to show that the cost of administering the general manufacturer's excise is any different or will be any greater than the cost of any other tax that you might impose.

In that connection, Mr. Chairman, may I ask Mr. Stephenson a question?

Mr. MILLS. Yes.

Mr. LUTZ. Mr. Stephenson, we now have as I pointed out, a manufacturer's excise tax which embraces almost all—not quite all—say 75 or 80 percent, of the present excise levied by the Federal Government.

If you exclude the liquor and tobacco taxes, which are obviously collected at the point of final manufacture, you would have something like 4 billions or a little more of taxes which are collected at the manufacturing level.

The small yield of the retail taxes we can throw out and there are 1 or 2 others that might also have to be excluded, but the question is this, Mr. Stephenson:

We now have all of those costs to which you referred embedded in prices. All of these costs are there now. They are greater costs

really than would be the case under the uniform tax which I propose, which at present levels of business and consumption could not be more than 4 percent and certainly not more than 5 percent of the manufacturer's level instead of running up to 8 and 10 and in a few cases more than that, but those costs are all there now.

Whatever addition to insurance, to commissions, rents, to interest and all of the other carrying costs are there now.

All that we propose or all that I propose here—and I inadvertently said "we" because I am in a sense speaking for the plan that the Nanional Association of Manufacturers has proposed—all that is involved there is to get the same amount of revenue that the Government is now getting.

Therefore, all that is involved is the same amount of cost which is now being incurred in the handling of these present taxes, and how can it result in any additional burden, merely by spreading the same amount of cost at a lower level of cost across a broader base than we now have concentrated on a narrow base?

Mr. STEPHENSON. It makes a terrific difference.

No. 1, it is a question of where the tax is imposed. I dislike to talk about association against association, but if you will read the proposal of the association to which Professor Lutz refers, it says specifically that as the population grows, and as there is a greater national income, that income taxes on corporations and higher said individuals should be reduced over a period of time until they reach a level of 35 percent, at which time there should be a constitutional limitation placed on the raising of any higher income-tax rates.

It says further in their program that excises do not need to have constitutional limitations placed upon them.

A great many people see the imposition of a broad based excise tax as the means for shifting the burden of taxation from the corporation and the higher paid individual to the broad segment of the population who must spend, and we do know they spend, most or all of their income for the normal processes of living.

We all know—I live in a factory town. We know the average factory worker is earning very good money today but he spends it.

He spends it all. He buys goods with it.

Now the thing that retailing is trying to avoid if possible is limiting the buying power of that worker for goods and services.

We do not see any advantage in reducing the taxes, say, on myself, or of the tax on our corporation in order to shift that tax, the incidence of the tax to somebody else.

It is true that the public pays all taxes. The consumers pay all taxes, but which consumer are you talking about?

Which one of them?

Are you talking about the consumer who has his income derived from dividends?

He does not get quite as much with the present high corporate income tax, or if he is at very high income levels he has to pay high progressive taxes, there is no question about that, but if in order to relieve him we load the little fellow, the little fellow can't buy quite as much.

Now maybe I do not figure this thing right, but Dr. Lutz spoke about that part of the excise taxes which would be the subject of repeal perhaps at some time in the future. He figures about $4,600

million, and that includes about $835 millions in gasoline taxes, it includes automobile taxes, etc.

I have heard economists—I am not an economist but just a person who works in business—I have heard economists estimate that the dollar turns anywhere from 3 to 5 times in the process of paying me my salary, then I buy something and salaries are paid from the purchase price of the goods I purchased, etc.

Let's assume we are talking about three times. We know the factory worker and the lower-paid individual spends his money. If we multiply that approximately $4.6 billion worth of excise taxes by 3, that means that they would generate about $14.7 billion in additional movement of goods and services, new payrolls, new corporate profits that I believe would replace most, if not all, of the missing excise-tax revenue, and further than that, referring to our good friend Senator Goldwater, and in which I can't help but concur, I think a little bit of Government economy would pick up the rest of our troubles and the Federal revenue would be as well off without those excises as it is with them.

I do not know whether I have answered your question, Dr. Lutz.

Mr. LUTZ. I am afraid you have not and I can understand how you have not figured it quite right.

Had you been here last week when a representative of the NAM discussed in greater detail the general theory under which our plan is supposed to operate, when we talked about reducing the rate of corporate tax and the progressive element in the individual taxes, we are not suggesting that any part of that cost be shifted to anybody else.

The growth of the economy will provide enough margin so that those reductions can be made without any transfer of burden to excise taxpayers, to small income groups, consumers, or anybody else.

Mr. MILLS. I had intended to ask Mr. Curtis to proceed with the interrogation, but in the light of your statement I have one question I want to ask:

Let me see if I understand the plan to which you allude.

You would provide in the field of excises for an evening of the burdens presently levied through excises except for tobacco and alcohol, among all commodities, except food commodities?

Mr. LUTZ. Yes.

Mr. MILLS. So that you get the same amount of money, but not from the few limited items on which there is at present an excise tax?

Mr. LUTZ. That is right.

Mr. MILLS. Then at the same time you would propose adoption of a constitutional amendment to limit the income tax to a maximum rate of 35 percent, except in case of national emergency when the rate might be raised by Congress?

Mr. LUTZ. I would have to take one exception to your statement.

Mr. MILLS. I want to understand the situation, sir.

Mr. LUTZ. We do not say at the same time.

The proposal for a constitutional amendment to limit the rates of income tax stands on its own bottom and is not in any way tied into or made conditional upon, or in any other way related to this proposal.

Mr. MILLS. But you would like to see both of them enacted?

Mr. LUTZ. Yes. The NAM does have a policy position supporting in principle the notion of a limitation of rates of income and estate

or inheritance taxes, but it is in no way connected with the proposal that we advanced here last week.

Mr. MILLS. Well, you would not shift that loss in income-tax revenue over to excises?

Mr. LUTZ. Not at all.

This loss of revenue is only an apparent loss. As the economy grows you can reduce the rates as we have suggested, and still maintain the same level of revenue that you are now getting.

Mr. MILLS. But if you once get the general sales tax, as you might call it except for its application to food at a national level, and it amounts to 3 percent, say, to begin with, because it takes that levy to equal the amount you now get from everything except tobacco and alcohol, and you have the constitutional limitation of 35 percent on income taxes, and an emergency does arise, what do you think the Congress would be prone to do?

Mr. LUTZ. I would say that any amendment that could be drafted and ratified for the limitation of income-tax rates would certainly contain an escape clause providing that in any case of grave emergency, any limit, whether 35 percent or some other, would be waived under that emergency.

Mr. MILLS. I understand that is a part of the plan that is conceived by the NAM, that there would be such waiver in case of national emergency but I am asking you your opinion of what you think the Congress would do?

Mr. LUTZ. I think they would waive it.

Mr. MILLS. You do not think they would up the sales tax at all?

Mr. LUTZ. Well, if you are going to raise income taxes and need a lot of money, it may be that they will also raise the excise tax.

Mr. MILLS. I am sure they would.

Mr. STEPHENSON. I am sure they would, too.

Mr. LUTZ. I do not know that that would be too serious myself. I think you have got to keep a balance.

Mr. MILLS. Mr. Stephenson seems to think it would, is that right?

Mr. STEPHENSON. I am pretty positive that it would wind up with many of our labor force behind the eight ball without a job.

Mr. MILLS. Mr. Curtis?

Mr. CURTIS. Mr. Chairman, I thought I would start on some details and then go to generalities.

Mr. Due, I was interested in your separation of the various excises we now have and I would like to comment on them a little bit and get your comments.

First, I notice you do not have an item for these emergency taxes and you include them under luxuries.

For instance, transportation tax and communication are imposed not on the theory of luxury, but during the war to sort of limit travel and the use of those facilities.

I just wondered why you included them in luxuries.

Mr. DUE. Well, it is true that they were largely introduced for the purpose of restricting use, but while the need for restricting use has long since vanished, the taxes have been carried on. They seem to fall more logically into the luxury category than any other. A classification is always somewhat arbitrary and I would be quite happy to set up a classification which listed them separately. But these taxes are frequently considered to be of the luxury character.

Mr. CURTIS. I think in the field of excises the law of inertia certainly operates. It is difficult to get one imposed and once it is in there it is pretty hard to blast it out again.

Both of them were put in there for that reason.

Incidentally their operation to a large extent, would you agree, amount to a general sales tax, at least as far as transportation and communication are used in business, where those taxes come out in the end product?

Mr. DUE. Yes.

About 80 percent of telegrams are business telegrams, and this tax, like the tax on freight and even that on passenger transportation—half perhaps of passenger transportation is for business purposes—are paid for by business firms.

These are at least in part miniature sales taxes applying, incidentally to food, which would likely be exempt under a Federal sales-tax levy.

Mr. CURTIS. I would comment also on the highway-benefit excises; they amount to almost a sales tax, as they become absorbed in the product's price.

I would like to comment also on those, and something that personally I am very much concerned about and I think a lot of thought should be given to the following facts.

Those taxes are pretty close to being earmarked taxes and, of course, according to the interpretation of our Constitution, the Federal Constitution, we cannot have earmarked taxes.

I might comment, I think the reason for that is just as sound as when our Constitution was adopted, because if we get earmarking taxes at the Federal level we will find that we are going to cut down our general revenue fund and our general revenue fund has to remain intact for defense, if for no other purpose. But I wonder if the panel would comment on this, what I regard at any rate, as the dangerous trend in thinking at the national level, of actually talking about earmarked taxes.

We certainly had it in our discussions on the highway bill, and it is very much before us at this very time, as to whether or not we should, or whether we can impose an earmark tax.

We have been able to dance around the constitutional language, or rather the courts' interpretation but the thinking is still there and apparently no one, at least I have heard very few people express the danger that I see.

Mr. STEPHENSON. May I make a comment, Mr. Curtis?

Mr. CURTIS. Yes.

I want a comment.

Mr. STEPHENSON. I cannot speak at the Federal level on this but I can speak from the State level.

Michigan has many earmarked taxes.

Mr. CURTIS. States can do that.

Mr. STEPHENSON. But the effect is just the same. It puts a rigidity in the use of funds and use of State revenues which is almost unmanageable.

Michigan is in financial trouble, hot water all the time because of the high incidence of earmarked taxes and we are constantly leveling new taxes to try to get around this problem of having sufficient funds to run the general operation of the State.

Mr. STEPHENSON. I think if earmarked taxes should be avoided, that should be done by all means.

Mr. CURTIS. I am glad to get that observation. I have heard that some State authorities have expressed that fear.

You can always get by with one earmarked tax but as soon as you do it——

Mr. STEPHENSON. That is a temptation for another earmarked tax.

Mr. CURTIS. That is right.

Mr. Lutz?

Mr. LUTZ. I would like to agree with what has been said about the danger of earmarked levies whether at the State or Federal level.

When the legislature sets aside particular taxes to support specific services it has undermined the budgetary process. The services will be neither princes nor paupers. There is no way of determining how much revenue will be produced over the long run by given separate taxes and a service which gets one of the rich sources of revenue will live in luxury and another service that might be just as important for the general welfare as the first one is going to be on a very lean diet because the tax assigned to it happens to be relatively unproductive.

I would like to ask Professor Due a question about his table here.

Of course if you had read what I say, I do not make the attempt to classify anything as a luxury.

People will have a right to spend their money on anything they want to buy after paying income tax and if they want to buy one thing rather than another it is O. K.

Anything that I do not want to buy I can call a luxury from my personal standpoint. But how do you reconcile your classification of light bulbs as a luxury, or matches, or, well, let's take safe-deposit boxes?

We believe that everybody should try to save and get ahead, and if possible, acquire some kind of property.

It may be the deed to his house, it may be some savings bonds or insurance policies. If he does not have a safety box in which to keep those things, the only place that he can keep them is under the mattress, or behind a brick in the fireplace.

I think in the whole emphasis that we put in this country on getting ahead, and becoming an owner of property, and to that extent a kind of mainstay of the private economy that we all believe in, the safety box is hardly to be classed as a luxury; even a wife who wants to keep her marriage certificate intact would better have a safety box to put it in.

Mr. CURTIS. Before Professor Due comments I think it is a little unfair, and I started it—he was actually in my opinion being very helpful in laying these things out and I would hate to see him bound.

One of the members passed me a note of the definition of a luxury, "something that some people think other people should do without."

What is one man's meat is another man's poison.

Mr. ZELOMEK. A bulb in a factory is one thing, a bulb in your own kitchen is something else.

Mr. CURTIS. Possibly.

Professor?

Mr. DUE. Certainly I would not defend the tax on safety-deposit boxes nor would I defend hardly any of the other taxes in this category.

I use this name because it is the term which is commonly used with respect to these taxes and I included in the category of the ones which are frequently so classified.

This whole group of taxes should eventually be eliminated partly because of the difficulties of trying to get a workable definition of luxury.

I do not think Professor Lutz and I really disagree on this. I was not meaning to justify these taxes or say that these items should be called luxuries at all.

I was merely trying to set up some sort of reasonably logical classification of the excises to facilitate discussion of them.

Mr. CURTIS. I might say we on the Ways and Means Committee constantly receive comments on where do we get the idea this is a luxury.

I remember on baby talcum powder and on pocketbooks, all of the women in America were up in arms. I was intrigued with the fur people coming in and pointing out that fur is a material, and a $150 fur coat is considerably less luxurious than a thousand dollar cloth coat.

Mr. STEPHENSON. Which is the truth?

Mr. CURTIS. That is certainly the truth.

I remember some hearings we had on the Small Business Committee out in Indiana where this jewelry retailer was in there complaining about luxury excise taxes. He said in reference to a haberdasher next door, competing with him for the consumer dollar, that he personally thought a wedding ring was more a necessity than these fancy negligees that his competitor was selling next door. So this business of getting into calling them luxury items I think is an unfortunate thing.

I think maybe the law of inertia is what is actually bothering us—what happenjs to get stuck in for some reason or another stays in unless some one can blast it out.

I wanted to go on to more general discussion though of this problem of excises.

I might say this: the reason I brought up this question of earmarking is that it is in the excise field that that tends to take hold. That is why I thought it was pertinent to develop that somewhat, but the main thing I want to get to is this: using the terms regressive and progressive—of course the income tax has been referred to as a progressive tax, which it is, and the excise tax as regressive.

Now, the impact on the economy, the overall economy as to these two forms of tax is the thing that becomes of particular interest. It has been pointed out, I think Mr. Stephenson in your discussions about the need for the consumer dollar as opposed to the investment dollar.

Of course that has a place in there, so that I am not saying that you say one in the exclusion of the other.

Mr. STEPHENSON. That is like talking about which comes first, the chicken or the egg.

Mr. CURTIS. It is a balance. You have to have both.

Mr. STEPHENSON. As a person in business and deeply concerned with capital investment, we believe in the necessity for capital improvement in our business and every other business.

It has to be done because we can't employ people if we do not have facilities with which to give them jobs.

The point that I have tried to make is that income taxes, both on corporations and higher paid individuals, have not had as serious an impact on capital formation as many people seem to believe that they have had.

The records of the SEC are very clear on the point. I think that in the period from 1947 to 1955, about an 8-year period, the capital formation of listed companies has virtually doubled.

That does not count all the nonlisted companies in the country or all the proprietorships, single ownerships, and so forth, which have also had it.

For instance, it does not include the Ford Motor Co.'s tremendous capital improvement over the years.

I think that the estimates for this year are that retained earnings in corporations, listed corporations, will be something like $10.7 billion.

It is estimated that the retained earnings for 1956 will be about the same figure, which is at a higher rate than the capital formation in the 8 years I have talked about.

Mr. LUTZ. Would you explain——

Mr. STEPHENSON. Retained earnings to my mind is capital formation.

Mr. CURTIS. I think you are right.

Mr. LUTZ. Be a little more explicit as to what you mean by capital formation.

Mr. CURTIS. I consider retained earnings as much capital formation as if I go in the market and buy a stock or buy a stock in a new company. I also believe that the question of individuals buying stocks and bonds becomes a matter of choices.

Now, a lot of people would rather spend their money for living expenses than to save it, but I think that the SEC reported in the first quarter of this year that individuals absorbed some two and a half billion dollars of new capital stock, which is not too bad.

Mr. CURTIS. To clarify this, without getting into the details of which is right or wrong, you are basing your assumption on the fact that there has been ample capital formation?

Mr. STEPHENSON. There is never enough, Congressman; there is never enough.

We always want more, but we have not suffered yet too badly. A lot of small-business men just starting out are having a tough time. They always have a tough time, because they cannot get investors.

Nobody trusts them.

Mr. CURTIS. Let me throw out a suggestion to you.

I am not saying this is so, but just how we might have suffered, whether it is a suffering—a pressure is created to produce an economic performance and private enterprise does not meet the challenge.

The pressures then come down to Congress to get Government to do it, and therefore Government moves in and provides the capital formation.

I might suggest to you, sir, that in over a period of the past 10 or 20 years the amount of Government formation of capital has been tremendous.

I pointed out this ratio to other panels: For every private-invested dollar to Government dollar was a 9-to-1 ratio in 1929.

In 1952 that ratio declined to less than 5 to 1, which would indicate that maybe there is not all this capital in private enterprise ready to be formed to perform these services that our people are demanding. I think maybe we had better analyze this thing a little more carefully as to just how much capital formation we do need.

The society has been performing the services.

Our GNP is going up, but I think it becomes important for all of us to try to figure out where the capital formation that has permitted that to happen has come from.

Maybe it is perfectly O. K. for Government to be doing all this.

Maybe that is the best way, but I think we should know it.

Mr. Stephenson. I do not think many of us would agree that Government should do that much.

Mr. Curtis. I might think that way, too. I am not injecting that argument. I think it is important for us to know if that is so. If that is so, then I think it is necessary for us to do a little revision of our judgment on this question of where the tax might lie.

Mr. Lutz. Mr. Chairman, I don't think we can afford to be complacent about the capital formation situation at all. It is generally agreed that the labor force, by addition of new members, will grow at the rate of something like a million persons a year for some years to come. It is also generally agreed that on the average, it will take something like $11,000 or $12,000 of investment to provide an adequate and remunerative job for each member of the labor force. That adds up to some $11 billion to $12 billion that would be required every year. Now, you cite the enormous gross figures that are being put out as to the total amount of so-called investment. They run up to $30 billion, thirty-odd billion, and that sounds like an enormous amount, but that is the gross total.

A very large part of that is required at present prices to replace the wornout and the obsolete equipment. The capital consumption must be subtracted from that total gross figure, and the estimates that I have seen would indicate that when you subtract the cost of the capital consumption to take into account present cost of replacement of capital, that has been consumed, you only have about 5 or 6 billion dollars that you can really regard as net new addition to your capital fund.

Well, that you can see is only about half as much as you are going to need if the total requirement is going to be something like $11 billion to $12 billion in order to provide good jobs and good paying jobs for all of the new members of the labor force, plus better jobs for those who are still in the labor force.

I don't think we can be complacent about the capital-formation situation at all. I think it is serious.

Mr. Curtis. I now come to the thing that I really wanted to pose, that I was leading up to. It seems to me that we are talking about some sort of a balance; we do need the consumer dollar and we certainly need the investment dollar. We are talking about how our various tax systems, taxing methods, affect the investment and the consumer dollar.

Now, assuming that at this present time we do not want to place an additional burden, but maybe want to put a less burden on the

consumer dollar—and, of course, an excise is a burden on the consumer dollar—still do you think that, for instance, Mr. Stephenson, we ought to have in our Federal structure an excise system because of the possibility that in the future we might want to require it? Reverting back to my hypothesis, that the excise follows the law of inertia. It is pretty difficult to get it started, but if it is built in with low rates, it is not too difficult to put it into operation.

Mr. STEPHENSON. I think there are times when excises might be used.

Mr. CURTIS. On that basis——

Mr. STEPHENSON. Just a minute.

Mr. CURTIS. Go ahead.

Mr. STEPHENSON. I think in times of war emergency, if we need to reduce the consumption of certain types of products in order to use them for war purposes, necessary war purposes, that the consumption tax will have the effect of reducing the amount of that sort of thing that the public will use, and in such cases the consumption tax has a definite purpose. I don't think it has any place in the taxing structure for any other purpose at all.

Mr. CURTIS. In other words, that wouldn't be so much for revenue as to control the use of materials.

Mr. STEPHENSON. Yes.

Mr. ZELOMEK. Now, take this 20-percent tax. It is a regressive tax. Revenue would be increased if it were repealed. The rate was put at a high level in 1944, partly to control inflation, as well as to gain revenue.

Mr. CURTIS. Your cabaret tax was imposed in the wartime. It would do the same thing as transportation and communication tax, so it is in the same category.

Mr. ZELOMEK. In wartime it was. Our wartime aim was to control inflation, on the one hand, and second, increased revenue. It served its purpose. Yet we find now a decline in revenue from this tax from $71 million in 1946 to $38 million in 1954, and nothing has been done.

On the question of capital formation and of capital for industry as a whole, there is no serious problem, judging from the rate industry has grown since the war.

Mr. CURTIS. That was the question.

Mr. ZELOMEK. The answer is given by the growth of industry, by the growth of the economy.

Mr. CURTIS. The question he posed was rather growth. Take the housing industry, which has been one of the main factors in this recent rise from this recession. That industry is largely based upon capital formation of the Federal Government. What I am posing is to question just beyond the immediate fact that our economy is involved. It becomes a political question.

Mr. DUE. I wanted to make a comment on the matter of balance of taxes on consumption and income. From the standpoint of the taxpayer, what is important is not Federal taxes alone, but Federal, State, and local taxes. In recent years, the State and local expenditures have been increasing very rapidly, in a period in which Federal expenditures have tended to come down. State and local taxes today total about half the figure of Federal taxes. These tax systems rest very heavily on consumption. The State sales tax is the number one source of State revenue. This year several of the States increased their rate and cities have been moving rapidly in this field. In the last 6 months,

some 617 Illinois communities levied sales taxes. We already have a very substantial degree of consumption taxation, a factor the Federal Government must consider in developing its own tax program.

Mr. CURTIS. Thank you. As a matter of fact, you anticipated my last question and observation, because in discussing this balance, I wanted to bring out exactly what you are saying, that even though we might consider in our Federal tax structure the income tax which is basic feature, as far as our economy is concerned, we have to consider all taxes, and I will pose this question:

It seems, as Professor Due said, I think, by their very nature, the States are pretty well limited to the regressive types of taxes. Maybe they can come up with some other method, but I don't know what it is, so I would think that at the Federal level we would have to be selecting our taxes with some regard for what the State and local communities are going to have to use in their way of taxation. In considering this overall basic problem that we have under discussion, of what is the economic effect on our growth and stability of the tax structure that we adopt at the Federal level.

Mr. LUTZ. Before you leave that——

Mr. CURTIS. I said it so that there could be comment.

Mr. LUTZ. I would like to go back to what Mr. Zelomek said. I suspect he is arguing from one statistic. Now I think he made a very persuasive case as to the bad effects of the 20-percent tax on cabarets and other places of entertainment to which that tax applies. In the first place, he has also made a very powerful case in favor of a more moderate rate of taxation across the board because I suspect that if we were to include such services in a broadly based excise tax such as I have been discussing, and had a rate of no more than 4 or 5 percent, it wouldn't have had anything like the disastrous effect on the employment of musicians as it had had at 20 percent. But he also suggested if we were to get rid of all of the excise taxes there would be enough more employment and more income produced so that we would pick up the 4 or 5 billions of lost excise revenue by additional income tax revenue.

Now let's apply that in reverse. We would expect to find more unemployment in the places where consumption taxes are being imposed. Some 32 States—31 or 32 now have sales taxes at rates ranging around 2 to 3 percent, which would be roughly the equivalent, at the retail level of a manufacturers' tax, of 4 to 5 percent.

Is there any evidence that unemployment is any greater in the 32 States which now have that kind of tax than in the other 18 or 16, which have no sales taxes? I don't believe there is any such evidence, is there, aside from musicians. We will leave them out.

Mr. ZELOMEK. The unemployment in the fur industry illustrated very dramatically what has happened in other industries where you have had reduction in excise taxes. The point I made, Professor Lutz, was very simple. I said this: by elimination of the cabaret tax, increased income-tax payments would more than offset the loss of cabaret-tax receipts. I believe the same situation exists for some of the other excise taxes.

Mr. CURTIS. Of course, I might say too, Mr. Zelomek, the rate makes a great deal of difference in that, too. It is 20 percent in cabarets.

Mr. ZELOMEK. Twenty percent.

Mr. CURTIS. That is quite a bit of difference.

Mr. ZELOMEK. There is a very interesting fact in that connection. They imposed a 30-percent tax as of April 1, 1944. The economic impact of this 30-percent rate was so great that it was reduced to 20 percent as of July 1, 1944. And this was in wartime.

Mr. CURTIS. I might say that I find in a lot of tax thinking failure to keep in mind that there is a law of diminishing returns on any tax. I remember one panel in our February hearings, there was some dispute as to whether that was true, so I just posed the situation of protective tariffs, which, of course, is deliberate use of diminishing return rates to produce economic effects. I think that is very true. I don't care whether it is an excise tax or what. It may be more difficult to find where that point of diminishing return is in other forms of taxation. I don't think there is a tax that has ever been written that doesn't adhere to that law.

If the panel disagrees on anything I say, I hope they will so state.

Mr. ZELOMEK. There is a tendency to compare tax policy on excise with that of European and British in particular. I might say there is no problem, no comparison. Their problem is to curtail consumption. That is not our problem.

Mr. LUTZ. May I correct the record on one point, Mr. Chairman? The statement was made awhile ago that the war excise taxes, as the excise base was broadened during World War II by adding one thing after another and stepping up the rates, that all that was done in order to curtail consumption.

When we began some years ago in working around with this excise tax question I decided to go over the reports of the Ways and Means Committee in which those increases of tax and additions to the excise system were being proposed, and where the reports offered any justification at all, they always added this: this increase in the rate, or this addition to the tax, will not affect consumption.

It is a bit of folklore that has come down to us that we put those on for the purpose of reducing consumption and yet the Ways and Means Committee was careful to point out that in no case would it interfere with the volume of sales in this particular light.

Mr. MILLS. Mr. Lutz, I think it should be borne in mind that the Ways and Means Committee did not levy excise taxes in time of war for the purpose of limiting consumption. That was not the purpose. The Ways and Means Committee was concerned about a question of revenue.

Mr. LUTZ. Right.

Mr. MILLS. They levied excise taxes as well as increases in corporate and individual rates, for the desired purposes of obtaining additional revenue.

Mr. LUTZ. The impression has gotten around.

Mr. MILLS. I remember Leon Henderson and others from OPA, in some instances they would advise us that the effect of this fact might be to limit certain use or consumption of services or commodities, but the committee was not concerned with using taxation for that purpose.

Mr. ZELOMEK. As a matter of fact, in our discussion in those days of civilian supply in the OPA and OPS we were interested primarily to curtail consumption. That was the recommendation at that time.

Mr. MILLS. But I am referring to what prompted the Ways and Means Committee to enact the system of excise rates that we had during World War II.

Senator Douglas?

Senator DOUGLAS. The doubt that is in my mind is this: If we were to reduce or if we to put into effect a general sales tax at the manufacturers' level, even though it was limited initially to collect only $4 billion, let's say, in revenues, would it stay there? Would that be the thin edge of the wedge which through time would increase? Would we not have the emergencies to which Congressman Mills has referred? There would be a need for quick, immediate revenue, which would be an inducement to use the sales tax rather than income tax, which would operate only after a time. It is thought, too, that there are groups in society who prefer a sales tax to an income tax. Wouldn't an emergency make them feel their oats, so to speak, so that the net result would be that we would have an expansion of the sales or excise tax system and a relative decrease in the income tax structure? Mr. Stephenson?

Mr. STEPHENSON. Isn't it true, Senator Douglas, that the Canadian tax started out at 1 percent, and over the years has slowly grown to, I think it is around 10 percent at the present time, excepting on certain so-called luxury items where it goes as high as 25 percent. This very thing that you are talking about, happened there. I think it happened in other places where they have such forms of taxation on a broad base.

Senator DOUGLAS. Canada is sometimes held up to us as a model which we should imitate in the field of public finance.

Mr. STEPHENSON. I had a very interesting experience I would like to relate, about this question of the Canadian tax. We are told so often that the Canadian tax is a model and that people know about it and accept it as such so I sent one of our executives over into a Canadian department store with a button microphone, and a hidden tape recorder, and he interviewed customers to see what they knew about this tax.

We found that 55 percent of them didn't even know there was a tax on their merchandise. We found that 40 percent of them that we interviewed, and we interviewed a broad segment, we found 40 percent had a vague notion that there was a tax but they didn't have any idea how much.

We found about 3 percent who worked in stores who realized there was such a tax. Our executives told the customers of the store where the interviews were taking place, how much the tax was, and you should have heard them scream about these "damned hidden taxes."

Then we tried it out in our store. We sent this chap downstairs to interview our customers in the camera department, and in the appliance departments. We found that virtually 90 percent of the customers, American customers, had no knowledge of the excise tax.

Senator DOUGLAS. In other words, the tax consciousness of the citizens is anesthetized by the excise tax.

Mr. STEPHENSON. It certainly is. They have no realization of what is happening to them.

Mr. ZELOMEK. Senator Douglas, in studying this music tax, I interviewed many hotel owners. In explaining the closing of more than 450 entertainment rooms in their hotels, they blamed the 20-percent tax, and the fact that it was stated on the check, so that the patron was conscious of it. Patrons simply rebelled.

When the public is cognizant of a high tax it invariably begins to react violently to that tax.

Senator DOUGLAS. Mr. Stephenson's point is that they will not be cognizant of what is happening.

Mr. STEPHENSON. About the broad-based tax on merchandise they aren't cognizant. They just know that prices are high.

Senator DOUGLAS. In these matters, and I certainly do not wish to be discourteous to any of you, I remember in the 17th century, in discussing the French economy, one of the officials at the court of Louis XIV said, "The first policy of taxation is the ability to pluck a goose without the goose knowing that its feathers are gone."

Would you say that this was characteristic of the sales tax?

Mr. STEPHENSON. I would say that is characteristic of the broad-base sales tax. I have some good friends in England. They tell me the same story. Sir Dick Burbidge said, "For goodness sake, keep away from these broad-based sales taxes if you can. The public doesn't know about them, and we get criticized for the prices they have got to pay."

Mr. LUTZ. I was going to suggest, Senator, if Mr. Stephenson would take his tape recorder down to the doorway of the Hudson store, and started asking people to give a quick answer to how much income tax they pay, there would only be about 1 in 100 would could give him the right answer as to how much income tax they pay. If he asked them how much property tax they are paying, the same result; how much gasoline tax are they paying, a great many wouldn't know that.

I don't think it is too surprising. Most people don't go around trying to be a walking encyclopedia on their tax rates or anything else of that sort.

I do maintain, however, that if we had one excise-tax rate across the board, instead of the miscellany we have, there would be much better chance that people could be informed and would be likely to be informed than is the case under the present situation.

Senator DOUGLAS. Mr. Due, I understand you have studied the Canadian sales-tax system. Could you comment on the experience in Canada and tell us whether the tax has increased as Mr. Stephenson said or what has happened?

Mr. DUE. Well, just very briefly, Canada introduced the tax immediately after World War I.

Senator DOUGLAS. Would you speak more slowly?

Mr. DUE. Canada introduced the tax immediately after World War I, starting out at a low rate. The rate was soon increased up to 6 percent. The tax was very unpopular in these early days. The Canadian Manufacturers Association, for instance, tried its best to get the tax repealed and finally in the late twenties the Government announced that it was going to eliminate the tax gradually. If a tax of this sort is taken off all at once serious injury is done to merchants who have stocks of goods on hand. The Government began a program of reducing the tax one point year by year. The rate came down to 1 percent; then the depression struck, and in an effort to get more revenue the Government shoved the tax rate up from 1 to 8 percent, within 5 years. It was kept at 8 percent for 15 years, and then it was raised to 10 percent in 1951; the additional 2 percentage points were earmarked for the old-age security fund.

Senator DOUGLAS. Was that a retail sales tax?

Mr. DUE. It is a manufacturers' sales tax.

It is very similar to the type of tax which the NAM proposes except that it has more exemptions. For instance, industrial machinery, fuel, building materials, as well as most food products, are exempt from the tax.

Senator DOUGLAS. What effect has that had on income taxation in Canada?

Mr. DUE. I think it is safe to generalize that it has resulted in some lowering of income taxes. It is always hard to be sure of an answer to this question.

The basic Canadian income-tax structure is now somewhat lower than the American. The Government now deliberately justifies the sales tax as a permanent element in the tax structure and as part of the justification advances the argument that the tax allows income taxes to be somewhat lower than could otherwise be the case.

Mr. LUTZ. Mr. Due, isn't it true, at least I was told by a representative of the Canadian Manufacturers Association when I was in Canada a few years ago that while there were these periodic outbursts against manufacturers' excise tax, whenever they came to the question, How are you going to make up the revenue that you are now getting from that tax? everybody backed off and said, "Well, we will live with what we have instead of increasing income taxes or devising some other kind of tax that would be less palatable than the excise tax."

Mr. DUE. I think this is probably true in recent years. The CMA abandoned its fight against the tax some 15 years ago. There is really almost no organized opposition to the tax in Canada. It has simply become to be accepted as a permanent part of the tax structure. The opposition members in Parliament naturally criticize it but throughout the country as a whole there is very little organized opposition. When a sales tax is in operation long enough people become reconciled to it and apparently just forget about it. As Mr. Stephenson pointed out the tax is very thoroughly hidden. The Government apparently regards this as a desirable feature.

Mr. STEPHENSON. I would like to make two points on that, if I may. In the first place, the Canadian retailers take their full markup on the tax. That isn't hearsay, or theory; it is a specific fact which has been confirmed to me by the retailers.

No. 2, the retailers, while there is no organized opposition as Professor Due says, the retailers are, we will say, nagging about it. The Canadian authorities are nagged to get these consumption taxes down because retailers are anxious to sell more goods. They don't make money not selling goods.

Mr. DUE. I think the opposition of the retailers is mainly against the excises rather than the general sales tax.

Mr. STEPHENSON. They are an additional excise tax charge on top of the 10 percent manufacturers' tax. However, the retailers will work on the 10 percent if they ever get down to that point.

Mr. MILLS. Senator Douglas would it disturb you if I were to ask a question at this point?

Senator DOUGLAS. Certainly not.

Mr. MILLS. There was one argument.

Would Professor Due or Mr. Stephenson be able to tell me whether or not since World War II there have been any reductions in Canada in the excise tax field?

Mr. DUE. The general sales tax has not come down at all. On the other hand, it was not raised during the war. It was left unchanged during the war mainly because the Government did not want to interfere with their price ceilings.

Mr. MILLS. There have been reductions in Canada in income and corporation taxes.

Mr. DUE. The Government has brought both corporate and personal income tax down. It introduced a very substantial dividend credit system for the income tax. The excise taxes have been used as a very deliberate instrument of fiscal policy. They have been raised sharply at certain times in the postwar period in Canada when there was a trade deficit, and at other times were brought down. The general level of excises is now somewhat lower in Canada than during World War II. Several of the excises were eliminated completely. One of the first repealed was the transportation tax on passengers.

Mr. LUTZ. It is true, isn't it, Professor Due, that shortly after World War II they did get rid of some of their special excises at very high rates, some of them as high as 25 percent?

Mr. DUE. Yes; particularly a few extremely high ones such as that of 80 percent on automobiles in excess of a certain value. These were brought down.

Senator DOUGLAS. I have only one other question to ask, and that is the relationship of the Federal tax structure to the State and local tax structure.

As I understand it, roughly seven-eighths of local taxes are derived from the general property tax. Of the State revenues, general sales taxes in 1954 and 1955, probably took in 23 percent of all State revenues; the gasoline tax took in 20 percent, the tobacco tax, 4 percent, alcoholic beverage sales and licenses, 5 percent; the total is about 51 percent.

Then if we include motor-vehicle taxes and operating licenses, that is another 10 percent, giving us 61 percent or nearly the two-thirds Mr. Due mentioned. We have variations of the sales tax comprising about two-thirds—close to two-thirds of State revenues.

Now sales taxes are certainly regressive. Everyone seems to agree on that, and general property taxes—and I speak with some restraint on this because Mr. Lutz has always been one of the great experts on the general property tax—as far as my experience goes, tends to be regressive, because the percentage of assessment tends to be higher in the case of workingmen's houses than in the case of industrial establishments or residences of the wealthy. Therefore, and this is the point I am trying to make; we have a regressive, and to a considerable degree highly regressive, system of State and local taxation.

Now the Federal system is progressive, so far as the income tax and so far as the corporation tax are concerned. But the Federal tax structure has in it the excise taxes, a large portion of which, particularly those on liquor and on tobacco, are regressive, as are certain other elements. The net result, according to Dr. Musgrave, is that if we take the tax structure for the Nation as a whole, it is roughly proportional on incomes up to $10,000 and slightly progressive thereafter.

I suppose the conclusion that one would draw from this would depend upon ones philosophy of taxation, and so forth. I happen to believe in the principle of progression. It would seem to me, at the very least, to be a backward step to move from progression in the Federal system to regression, thus producing not proportionality, but overall regression up to $10,000. Personally, I would go even further and say that what we need to do is to introduce a greater degree of progression in the tax structure as a whole, but certainly we should not change proportionality into regression on the incomes up to $10,000. I wonder if there are any comments on that?

Mr. LUTZ. Mr. Chairman, I believe that we submitted last week an examination of Professor Musgrave's data which tends to alter somewhat the conclusions that might be drawn from the tables which he originally developed, and were published at various places 2 or 3 years ago, and also the table which he has in the compendium.

The result which we get from that is shown in the material that was incorporated into the record last week. It is that so far as the State and local tax situation is concerned, it is moderately progressive from the $3,000 level, up. Now, there is a somewhat higher percentage of tax to income shown at $2,000 level for a typical urban 4-person family, but you must remember what Professor Pechman said, which I quoted in my paper, to the effect that the $0 to $2,000 income level is the one that we know least about, both with respect to the nature of the income and the character of the expenditures of persons in this income group, and therefore we should not be overhasty in drawing conclusions from these data.

I should like to point out, further, that this overall State and local comparison is likely to be misleading for another reason. I suggested in my paper four States—New Jersey, which has neither sales nor income tax; New York has an income tax but no sales tax; Illinois has a sales tax but no income tax; California has both sales and income tax.

I think if you want to be sufficiently accurate in the discussion to be on safe ground, you almost require a State-by-State study of the impact of the State and local system on different income levels, because I can't see any good result coming from lumping together even the four States that I have mentioned.

The State and local tax structure is so entirely different that a conclusion you might draw with respect to New Jersey might have no validity at all in either Illinois or California.

Senator DOUGLAS. Dr. Lutz, these figures which we have had compiled for us on overlapping taxes in the United States come from the Tax Division of the United States Treasury Department and the Bureau of the Census State tax collections. Those on local taxes come from the historical review of State and local government financing, published by the Bureau of Census in June of 1948, and various other Census publications and reports from the Treasury Department and the Bureau of Census. As you know, the Census publishes periodical figures on State and local finances, and the figures which I have given are countrywide averages—countrywide totals, not figures for any specific State. They do seem to indicate, as I say, that 61 percent of the State taxes is derived from licenses, motor-fuel taxes and sales taxes, and only 16 percent comes from State income

taxes, including corporation taxes. We all know, of course that the general property tax furnishes the basis for local revenues.

It would seem to me the conclusion is clear that so far as State and local taxation is concerned the system is regressive. Further, there are regressive features even in the Federal system. What the Federal system largely does is to lift the regressive nature of the State and local system up to proportionality, until you reach the $10,000 point, and then, of course, it is true the Federal system then introduces an element of progression in the tax system as a whole.

I would like to put this into the record: 48 States have gasoline taxes, 32 States have general sales taxes; 29 have taxes on distilled spirits, 17 have a liquor monopoly; 41 have cigarette taxes. Cigarette taxes, I believe, came in in the twenties and thirties; did they not? What has been happening on the State level seems to be a movement into the field of sales tax. Now, if this is to spread into the Federal field, I think there would be two serious disadvantages. In the larger sense it would mean a regressive tax system. In the second phase it would mean we would have the Federal Government, as I think Mr. Stephenson mentioned in his paper, going into the field which the States have now more or less marked out for their own, and from which it seems difficult to dislodge them.

That is all, Mr. Chairman.

Mr. MILLS. In addressing the questions to this panel, I would like to repeat the observation that I have made during each panel discussion: What we are looking for in these hearings are economic appraisals of the present tax system in the light of our objectives of economic growth and stability and ways in which we might improve our tax system to meet these objectives.

In this connection, three basic standards have been offered for evaluating any of the features of the tax system with which we are concerned in these hearings. The first one is as follows: Does it contribute to the built-in stabilizing capacity of the tax system?

Second, does it promote the most efficient use and allocation of our resources and so encourage balanced economic growth?

Three, does it strengthen or weaken the competitive position of small and new businesses in the economy?

Let us look at the subject matter before us this afternoon in the light of these three standards.

Professor Due, will you begin the comment?

Mr. DUE. With respect to economic stability and built-in stabilization, I think the present excise taxes or a general sales tax offer some contribution. The yield tends to rise in periods of inflation and fall in periods of depression. On the other hand, they contribute much less than the income taxes, since the income-tax yields move in much greater proportion. They fall off to much greater extent in depressions and rise much more rapidly in inflation. From the standpoint of economic stability, the commodity taxes in general are inferior to the income taxation in general. As among the various present excise taxes, some of them are obviously better than others. The yield of the tax on automobiles would fall very drastically in depression while the yield of the tax on cigarettes would fall very slightly.

In the matter of resource allocation, and efficient use of resources, the excise taxes, of course, have the very objectionable feature of dis-

torting consumption patterns, by encouraging people to buy some things instead of others. We put a substantial tax on cameras so some people will buy other things instead. This interferes with the use of the resources in the way which would make maximize consumers' satisfaction. On this score, the sales tax is a better tax, in the sense that it is uniform. This is one of the few arguments for general sales taxation, as compared to excises, which does have merit.

From the standpoint of economic growth, the excises and the sales taxes of course probably affect some consumption somewhat more than income taxes. This brings us back to the question we discussed earlier; which is the limiting factor of economic growth—consumption or investment? The commodity taxes, I think, in general will have less adverse effects on incentives of business firms for expansion than income taxes, but on the other hand, dollar for dollar, they will probably have more adverse effect on consumption. This is Mr. Stephenson's point.

I am inclined to feel that in the coming years, the greatest difficulties may be on the consumption end.

One other aspect on this matter of use of resources requires emphasis. One percent tax which causes serious interference with use of resources is the tax on transportation of freight, which encourages firms to develop use of their own trucks in order to escape the tax. This, in turn, interferes with the building up of a good public-transportation system. Some firms, of course, won't develop their own trucklines, regardless of tax, but certainly the margin between using public transportation and using the firm's own vehicles, in some cases, is bound to be affected by a 3 percent tax.

Finally, with respect to the matter of small businesses, the sales and excise taxes affect them in part by the troublesome compliance problems created. Also, if the tax is levied on the manufacturing level, as are most of the excises, additional money capital is required and it is more difficult for small firms to get started.

Finally, once again, the excise on freight is particularly injurious to small businesses because they are the ones least capable economically of developing their own transportation. Larger firms are able to do so more easily, and thus escape tax in the manner in which the smaller firm cannot do.

Mr. MILLS. Mr. Lutz, would you comment on the three standards?

Mr. LUTZ. Yes, Mr. Chairman.

I should like to point out at the outset, that Professor Due's comments were built around the present system of excises, including the tax on transportation, and I have already made it clear that I have no brief for the present discriminatory system. I think a uniform tax of a moderate rate across the board, to supply the Federal Government with at least as much revenue as it is now getting from excise taxes, would be a very substantial contribution to the stability of the economy.

In that connection, may I read a paragraph from an editorial which appeared in the New York Times last Saturday, December 10. It says:

That the income tax should be the main reliance of the Federal Government, few will seriously argue, but a country that is seeking a stable economy is giving a hostage to fortune when it places almost its entire reliance on any one type of tax, especially when that tax is itself a highly unstable one.

In other words, the income tax produces luxuriantly in boom times and goes to pieces at any sign of a reaction, or economic disturbance.

I think we can say also that the uniform tax at a moderate across-the-board rate will promote efficient use of our economic resources. It will not have the bad effects which Mr. Due attributed, rightly, to the present discriminatory excises, because under a uniform tax across the board, there would be no selective diversion of either consumption or investment into the one line as compared to another.

I think it would be beneficial from the standpoint of small and new business. I think the principal advantage that can be expected taxwise for small and new busines is to reduce the high and burdensome rates of corporation tax and the discriminatory effects of the high rates of progressive income tax.

I have already made it clear that we do not propose any shift of tax burdens to excise taxpayers as a result of the series of reductions in the corporation and individual income tax which we are proposing. That reduction can be effected over the next few years out of the growth factor of the economy itself, but so far as small and new business is concerned, I think we have a great deal more to fear for their future welfare and prosperity from the continuance of the present burdensome rates of income tax than we have from a low rate, moderate tax across the board on the end products of manufacture designed for consumption.

Mr. MILLS. Professor Lutz, I am sure it is my fault. You misunderstood my point, I think, with respect to the question of built-in stabilizing capacity of the tax system. I was not thinking in terms of stabilization of revenues, or stabilizing revenues. I was thinking in terms of stabilization of economic activity, full employment, and stable prices—things of that sort.

Mr. LUTZ. Well, as to that general question of stabilizing the economy——

Mr. MILLS. The effect of a sales or excise tax, whether they enhance this built-in stabilizing capacity of the tax system or diminish it.

Mr. LUTZ. At this late hour I don't want to get into a prolonged argument about whether or not we should use or look upon the tax system as a factor be used for the stabilization of the economy.

Mr. MILLS. You and I are going to talk about that a little later on, I hope. If it is agreeable with you—I want to ask you some questions about it.

Mr. LUTZ. I still stand by the uniform excise tax at a moderate rate at just as good a stabilizer, if you want to put it in those terms for the economy, as excessive reliance on high and punishing rates of corporate and individual income tax would not promote stability.

Mr. MILLS. In the question of built-in stabilizing capacity of the tax system, we have to take into account, I think, the question of the neutral effect, or lack of neutral effect of a tax, do we not, as well as in the case of use of resources, we must consider that point.

Mr. LUTZ. Let's look at this question of built-in stabilizers. Now I have been impressed in reading many of the papers in this compendium, with the emphasis that is put upon the use of taxation to control inflation. In most of those papers they never carry the argument or the logic beyond that point. I have found very few, if any,

cases in which they followed through with the tax money that is collected to see what was done with it.

Obviously, if the Government collects a large amount of taxes in an inflationary or boom period, and proceeds to spend the money on new programs, it will have no effect whatever on the supply of money in the economy and no impressive effect on the inflationary tendency.

As a matter of fact, the only way in which the Government can employ taxation to syphon off excess money supply, as purchasing power in the economy, in order to put a damper on a boom that may be getting too far, is either to hold that money as an idle cash hoard in the Treasury general fund balance, or to use it in retiring bank-held debt. If this is done, then the surplus-revenue collections are being made for the purpose intended, but if you just go out and say "We are going to retire debt," and you retire debt in the hands of nonbanking institutions, or individuals, you haven't done a thing except transfer purchasing power from the taxpayers to the bondholders; is that right?

Senator DOUGLAS. Dr. Lutz, we find ourselves in complete agreement.

Mr. LUTZ. We are making progress.

Mr. MILLS. Professor Lutz, if you and Senator Douglas are in agreement, I want to join you, but before I do——

Senator DOUGLAS. The agreement will not be for long.

Mr. MILLS. Before I join you I want to ask this question: If we take the position that taxation or the tax system should not be used to control inflation, then aren't we compelled to take the position that taxation should not be used to create inflation?

Mr. LUTZ. I am not sure that I follow you as to how taxation is going to create inflation.

Mr. MILLS. I thought—I am sorry I did not put the question right then.

If the tax system can be used to control inflation—and I assume it can because you do not think it should be, then a tax system could be used to create inflation, could it not?

Mr. LUTZ. No. You are around the corner from me there. I do not think I am keeping up with you.

Mr. MILLS. One of the great arguments that is being made now, that if tax rates are reduced, we create inflation.

Mr. LUTZ. If tax rates are reduced because the Government is spending less money, you have not made any contribution one way or the other.

I am sorry we got away from this balanced-budget proposition.

Mr. MILLS. You do not agree with these people then who say that if we reduce taxes at the present time we tend to create inflation?

I am not talking about excise taxes.

Mr. LUTZ. You are talking about taxes in general. If we reduce taxes now because the Government can live within a lower level of expenditures, we are not doing anything to create inflation.

Mr. MILLS. I want to get you and my dear friend, Mr. Reed, from New York, together, for Mr. Reed has been making statements recently, and I think correctly, that there is the possibility that reductions in taxes at the present time will be inflationary.

Mr. LUTZ. I do not think I could agree with that. I think if we have got any serious inflationary situation, the place to look for control of it is monetary policy, not in fiscal policy.

Mr. MILLS. You mean you do not see any elements of possibility of inflationary pressures at the present time if tax rates are reduced?

Mr. LUTZ. If tax rates are reduced the way that we are proposing that they be reduced, I suspect that a considerable part of the income left with taxpayers will go into additional investment, not necessarily into consumption at all.

I think if you confine your tax structure——

Mr. MILLS. You are losing me now. I gather from what you say, then, that spending for investment can never have an inflationary effect?

Mr. LUTZ. In effect, yes, because as you spend through investment channels you create more productive capacity, and as the productive capacity results in an enlarged flow of goods and services into the market, you are by that very fact keeping the demand and supply in balance so that there would be a very much less danger of what you would call inflation as a result of that than there would be if you reduced, or made all of your tax reduction at a point where consumption spending rather than investment spending was likely to take place.

Mr. MILLS. We have been told by other panelists that you can create inflationary pressures both through increased investment and increased consumption.

Now, you do not agree with that?

Mr. LUTZ. I would say that if those panelists went on to make this point, namely, that we are already bumping the ceiling of available resources and manpower, you might through the effort to do more investing simply drive up the prices of raw materials, of inventories, of capital goods generally, and not really be able to enlarge substantially that flow of output which I would rely upon to keep demand and supply in balance.

Mr. MILLS. Professor Lutz, when you have full employment, how can you invest in more facilities, which will of necessity require additional employees, without increasing inflationary pressures, the same way that you can increase inflationary pressures by giving people more money to spend than there are commodities to buy?

Doesn't it work both ways?

I am having a most enjoyable discussion with you on this very detailed and intricate problem of economics, and if you can satisfy me on this point about inflation I will not have so much reluctance about tax reduction in the near future.

Mr. LUTZ. I would say that under the circumstances you outline the principal outlet for additional investment would be an improved method of production, better tools and machines instead of more of the same kind, and that that would probably be your escape hatch if you could find one for additional investment.

I think we need better tools all the time.

Mr. MILLS. That would require additional resources that are already being used at capacity, would it not?

Mr. LUTZ. Well, it would mean a different direction of the application of those resources, instead of merely making more machines of the kind they were using last year, or 5 years ago, we would be making, or using the same flow of steel and copper and aluminum, the available flow, in the creation of better machines—something that could make more products or a better product at less cost.

Mr. MILLS. Now if I need steel, for example, and I can only get today just what I need, and you come along, because of something we have done that encourages you to invest in something wherein you need steel, and you undertake to get my steel away from me, you know what you are going to have to do to get it, don't you?

You are going to have to bid the price up to where I can't afford to pay and isn't that inflationary pressure?

Mr. LUTZ. I am hoping I would not have to take your steel away from you.

Mr. MILLS. It is too bad we had to use a personal example in this case.

Mr. LUTZ. I think it is.

Mr. MILLS. Unless you want to say something further, let's go to Mr. Stephenson on the three standards.

Mr. STEPHENSON. It seems in 1955, this question of stabilization and contributing to economic growth is somewhat academic because we are bumping along on top of the ceiling anyway.

We are not always going to be in a 1955. I do not believe we will always go up and never have to come down along the line somewhere, therefore I think my answer to cover all four questions, for both large and small business, stabilization, and all the rest of it is that if we can make it possible for the consumer to consume, if we fix it so we do not restrict his ability to consume, that he will automatically create employment.

I also want to say on the other side of the program that if the consumer has a demand for goods, and he creates employment to produce the goods, the business manager will find a way to increase his plant.

The business manager has all sorts of sources for money. He can borrow the money from pension funds, banks or insurance companies; he can get money from personal investment, even though the high-income person can't invest as much as he would like to perhaps, he can get money through cash flow out of depreciation, he will get money from retained earnings and somehow he will be able to create this additional plant facility that he needs.

I think the whole thing is a two-way street.

We have to produce, it is true; but I am sure that the steel mills won't produce structural steel if somebody does not want to buy structural steel, and I am sure that the man who manufactures shoes is not going to manufacture shoes unless somebody wants to buy shoes, so I think that we are not talking as if production was the paramount, all-important thing or as if consumption were the paramount, all-important thing.

Both sides are important. Therefore, it seems to me that we must keep our people in a position to be able to buy freely. We must not restrict their capacity to buy through some fiscal policy at the Federal level, and if we can keep the consumer buying, I think we will find that most of these other things will pretty well take care of themselves.

Mr. LUTZ. Mr. Chairman, Mr. Stephenson a while ago mentioned the chicken and the egg problem, and I would conclude from what he has just now said that he knows which comes first.

Mr. ZELOMEK. Mr. Congressman, I am in a very peculiar position here.

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My case history is applicable to 2 of the 4 points you raised. I will discuss the others later on.

Mr. MILLS. On that point, we appreciate very much your bringing to us this case history. We would not want the record to indicate that you have come here to advise us generally and have made a special plea for any one industry.

You have not done that. I want the record to show clearly that you were to present a case history of the tax you have studied so that we might have the benefit of the analysis of excise taxes in a particular case.

Mr. ZELOMEK. First I want to comment on tax reduction and its impact on inflation.

As a working economist it is my humble opinion that a tax reduction now, or early in 1956, would definitely be inflationary. By midyear, however, it is possible that this will no longer be the case.

Now I believe, in answer to your first question, that a Federal excise and sales tax cannot help stabilization. Second, the particular tax I referred to does not help us use some important human resources adequately, profitably, or soundly. And as far as controlled economic growth is concerned, it is my opinion also that a sales and excise tax does not contribute to economic growth. Fourthly, such taxes are more harmful for small business than to large business.

Mr. MILLS. And to new businesses?

Mr. ZELOMEK. Yes, sir.

Mr. MILLS. Professor Due, I want to come back to you if I may, and ask if you have any comment on this very scholarly discussion that Professor Lutz and I had on the evils of inflation and whether or not the tax sytsem may properly be utilized to create inflation or to prevent inflation.

Mr. DUE. I think both taxes and Federal expenditures have very definite effects on inflationary trends.

I think that a good case can be made for making deliberate adjustments in taxes for the purpose of preventing inflation.

It will not always be easy to accomplish precisely the desired results but I feel that fiscal policy is one justifiable method of attempting to control inflation on the one hand and attempting to alleviate or prevent depression on the other hand.

Mr. MILLS. Thank you, Professor Due.

I have been referring in the course of the hearings to balanced economic growth, and I think we include in this concept the idea that if we provided too much tax encouragement for consumption relative to investment, we might find that the increase in living standards is arrested by failure to increase our production capacity rapidly enough, whereas if we encourage an excessive rate of capital formation in relation to consumption, we may encounter serious difficulties in keeping growing productive capacity profitably in use.

Now if we provide a substantial shift in emphasis in our tax system from income taxes to consumption taxes, as some have proposed, wouldn't we run a serious risk of destroying the balance in our tax system necessary to insure balanced economic growth, both from a consumption and investment standpoint?

Mr. LUTZ. Are you assuming that we do have a satisfactorily balanced situation now?

Mr. MILLS. No.

What we are seeking in the course of these hearings, as a part of our study, is the attainment of balanced growth through proper tax policy.

Mr. ZELOMEK. Isn't it true, Congressman Mills, if you have an increase in consumption——

Mr. MILLS. Pardon me. Let me supplement this Mr. Zelomek. You have to assume that we evidently have had up to date a fairly balanced growth or we would not have attained the success in raising living standards and in increasing productive capacity that we have so far attained.

Mr. DUE. My general reaction is that a shift toward increased reliance on consumption taxes could very easily interfere with the balance which we seem to have attained very satisfactorily, reasonably satisfactory at least, in recent years.

Mr. MILLS. What you are saying, Professor Due, I assume, is that it would bring about a greater unbalance for the future?

Mr. DUE. Well, I think there is a certain danger of it.

Mr. MILLS. I see. Do you agree with that statement?

Mr. LUTZ. I don't know what Professor Due means by undue reliance on consumption taxes, but I would come back to your main point. It is true that we do seem to be in a fairly satisfactory situation, but if we consider what has happened on the side of capital formation, I think we will find in the first place that the inflation of World War II and some extent the years following was a boon to business which I don't think we can expect will continue.

There has been a very substantial rise of corporate debt, and there has been a serious deficiency, I think, in the amount of equity capital that has been provided in the years since World War II, and we have to consider what would happen if as the years go on more capital financing is done by way of corporate debt and business debt generally, rather than by getting more equity capital.

We will either have to revert to inflation again in order to enable them to carry this debt, or we will have to open the gates so that you can have a larger flow of equity investment, and a diminution of the tendency toward debt and bank and other fixed obligation financing, or you are likely to be in trouble.

I don't think we should be deceived by the apparent balance of the present time. We have to take into account the way it happened and that was very largely by inflation. We must look ahead to the future when we hope there won't be any more inflation, and decide how to get the additional capital fund that will be needed then in a manner that will not jeopardize the stability of business enterprise.

Mr. MILLS. Would you comment?

Mr. STEPHENSON. I would like to ask Professor Lutz a question and that is, Is it true that many business organizations have deliberately chosen the route of additional debt rather than the dilution of stockholder equity by bringing in new capital?

Mr. MILLS. Maybe they have fallen prey to their admonitions to the consumer. When you listen to radio and television and hear the encouragement to the consumer to buy this particular product—no payment expected before March, and only $1 then, maybe they, in their desire to sell the consumer on installment credit, have fallen prey to their own recommendation.

Mr. STEVENSON. Well, Congressman, the creditor has a strange way of making sure that you don't get too deep in the mud when you get into corporate debt, and——

Mr. MILLS. You mean a better way than the consumer?

Mr. STEPHENSON. That is for sure. If you go to the insurance company or a lender to borrow money he wants to make sure that you have proper relationships between your equity and the debt that you are taking on. Otherwise, he isn't going to accept you as a debtor. Therefore, I don't think, at least up to the present time—heaven only knows what the future will bring to us but I don't think up to the present time that many of our corporations or single proprietorships have gotten themselves into debt beyond their capacity to retire it over the period of retirement.

Mr. MILLS. We had one panelist, Mr. Stephenson—I guess it was last week—Mr. McCracken, who pointed out to us that the ratio of equity capital to total equity and debt had remained about the same since World War II.

Mr. STEPHENSON. Again, I am not an economist. I am just a person who is in business, but our own situation is that we have borrowed money and borrowed money substantially, and I would like to have this off the record if you don't mind.

(Discussion off the record.)

Mr. MILLS. In your opinion, as a businessman, is Mr. McCracken approximately correct when he says that the ratio of equity to debt percentage has remained fairly constant since World War II.

Mr. STEPHENSON. I think he is approximately correct. I think there are built-in controls in the process of borrowing and lending money which forces that balance to be retained. There are such things as the restriction of dividend payments, the requirement for maintaining a certain amount of working capital, restrictions on loans to officers and stockholders, and many other controls, in order to make sure that debt can be retired properly—and which keep debt in balance with your capital structure.

Mr. MILLS. I appreciate that. Mr. Zelomek.

Mr. ZELOMEK. I believe that balanced economic growth would be impeded by a sales or excise tax, or by commodity taxation.

Mr. MILLS. You know, I believe you are just about in the same position, the same fix I am, Mr. Zelomek. You just don't like excise taxes; do you?

Mr. ZELOMEK. The reason I don't like it is because I have had to live with them for 30 years. Seeing them operative, at a practical level of the manufacturer and retailer, I say they are a destructive form of tax.

Mr. LUTZ. Mr. Zelomek, your trouble is you have been living with a bad system of excise taxes, not a good system.

Mr. ZELOMEK. As we study the history of commodity taxes and sales and excise taxes, we are convinced of one thing; they are easy to put in, hard to get rid of, and their effects are hard to determine.

Now, as far as resources are concerned, we are going to face a problem, and that is the problem of an expanding culture, as well as an expanding economy. That is why I am against a tax that is so depressing to musicians, who are so important as a cultural factor.

Mr. MILLS. Are there any further questions by members of the subcommittee?

Any further comments by members of the panel?

If not, then I hope we may have agreed upon at least ont thing; that this has been a most profitable session. I know the members of the subcommittee have enjoyed your being here very much. The contribution you have made to our study both in the compendium and in your appearance here is appreciated.

We thank you very much for being with us.

The subcommittee will stand adjourned until 10 tomorrow.

(Whereupon, at 4:40 p. m., the subcommittee adjourned, to reconvene at 10 a. m., Wednesday, December 14, 1955.)

FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

WEDNESDAY, DECEMBER 14, 1955

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON TAX POLICY OF THE
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The subcommittee met at 10 a. m., Hon. Wilbur D. Mills, chairman, presiding.

Present: Senators Paul H. Douglas and Barry Goldwater and Representative Thomas B. Curtis.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The subcommittee will come to order, please.

This morning's session of the Subcommittee on Tax Policy will be devoted to discussion of corporate-income taxation.

As was announced yesterday, our procedure is to hear from the panelists in the order in which their papers appear in the compendium, Federal Tax Policy for Economic Growth and Stability.

At the start of each of these sessions panelists will be given 5 minutes each to summarize their papers. We will hear from all panelists without interruption. The 5-minute rule will be adhered to. Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session.

I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee's questions.

Our first panelist this morning was to have been Mr. Herbert A. Leggett. He has been detained, apparently.

Our first panelist then will be Mr. Leonard L. Silverstein, of Washington, D. C.

Mr. SILVERSTEIN. Mr. Chairman and members of the subcommittee, my subject involves the impact of Federal taxes on corporate and intercorporate financial adjustments—stock dividends, mergers, corporate recapitalizations, and similar transactions.

One of the difficulties of public expression in this area arises from the inherent complexity of the matters involved. It often is difficult to discuss them intelligently without bogging down in technical tax and financial detail. To avoid this, my remarks, insofar as possible, will be made in terms of broad policy objectives only.

While it seems readily evident that the Federal income tax plays some role, doubtless often a significant one, in motivating and in shap-

ing various corporate financial rearrangements, it is considerably more difficult to pinpoint the sources and nature of the tax-law influence.

I suggest the following:

First, the existence of a wide potential of differing tax-rate effects, ranging from no tax, to capital gains at a maximum of 25 percent to a dividend tax with—in the highest brackets—confiscatory consequences?

Any of these tax rates may sometimes be produced in a given desired transaction.

Second, the failure of the Internal Revenue Code to correlate effectively these tax-rate effects with the economic substance of the various transactions in question.

Notwithstanding the considerable steps toward clarification achieved as part of the Internal Revenue Code of 1954, there still remains substantial confusion and mystery in the area surrounding corporate taxation.

Let me illustrate:

If a corporation desires to subdivide itself into more than one business each to carry on a previous function, its shareholders may suffer any of the described tax effects. The shareholders may receive stock giving them separate ownership of part of the former business at no cost or its assets may be received as capital gains or as a dividend.

Where only the dividend consequences appear possible the transaction may never in fact be consummated because of the prohibitive cost to the shareholders.

A distribution in stock of a corporation to a shareholder, changing its capitalization, may also create similar diverse consequences. There are myriad other examples.

They predominate in the area of closely held corporations.

In this context, the stimuli for tax framing and meticulous, artificial tax planning seems self-evident. This is not to suggest that the responsible corporate tax planner, who guides the businessman in this area, seeks loopholes; on the contrary adherence to tax formality becomes an absolute necessity if only to protect the businessman from the disastrous consequences of a confiscatory tax result which may destroy years of corporate growth.

In the light of the foregoing, it would seem that the influence of the income tax in generating transactions solely because of their tax advantages or disadvantages could be materially lessened, if by some technique the wide tax rate differential could be eliminated or lessened. To this end I suggest that:

First, the corporate investor frankly be given an opportunity to recover all, or substantially all, of his investment in the corporation before he becomes subjected to the income tax with respect to that investment. This is possible to some extent today, but only in the most strained and technical of circumstances.

Thereafter, that all corporate distributions to shareholders, except the most economically colorless, for example, a dividend of common stock on common stock, and whether or not as part of a corporate reorganization, be taxed at a uniform but relatively moderate rate.

In this manner, the tax cost would constitute an element of the transaction, but not necessarily a prohibitive one.

Sales of stock to third persons would be taxed as at present with adjustment dependent upon previous investment recovery.

The foregoing is merely an outline. It represents no solution, but primarily a suggestion toward reducing the tendency of the tax laws to cause the businessman to frame his activities in terms of their tax, rather than their economic consequences.

The details moreover are obviously difficult of accomplishment. I feel that these problems should, however, be brought to the attention of this committee, and that continuing study be given toward a re-examination of these problems of the corporate-tax field.

Mr. MILLS. Our next panelist is Mr. Harry J. Rudick, Lord, Day & Lord, New York.

Mr. RUDICK. There were assigned to me two segments of the area in which management policies are affected by the income tax on corporations: first, the effect on management policy of the penalty tax on corporations which improperly accumulate their earnings, that is, in order to save their shareholders from the imposition of the individual tax on such earnings; and second, the effect of the regular corporate tax on corporate expenditures for such items as advertising and sales promotion, expense accounts, research and development, employee benefits, and charitable contributions.

Referring first to the penalty tax on unreasonable accumulations of corporate profits, the conclusions I have reached are these:

1. In a limited area, comprising principally companies in which management owns the majority of the stock and a significant minority is held by outsiders, the penalty tax has been quite effective in forcing dividend distributions which would otherwise not have been made.

On the other hand, there is a significant area in which the penalty tax is ineffective.

This consists of companies where the stock is very closely owned and where the income is substantial. In such situations, it is cheaper for the company to pay the penalty tax than to distribute the dividend income.

2. The penalty section has not prevented any significant amount of legitimate corporation expansion.

3. The penalty tax does to some extent stimulate the acquisition of small businesses by larger ones and thus tends towards the concentration of business enterprises.

4. The tax does not affect managerial judgment in corporations which are publicly owned, but in the case of corporations which are particularly susceptible to the penalty, that is, closely owned or closely controlled corporations, it does often impel the owner-managers to action or inaction that would otherwise be absent.

5. The penalty tax on corporations improperly accumulating earnings must be kept in the statute. Its complete abolition, suggested by some, would provide a gateway to wholesale tax avoidance. The provisions imposing the tax are admittedly not ideal but they are better than nothing.

As to the second topic assigned to me, there can be no doubt that when the corporate income-tax rate is as high as it now is it will act as a powerful spur to deductible expenditures for expansion, business promotion and goodwill development and on such items as employees' life insurance, sick benefits, pension and profit-sharing plans.

At a 52 percent rate, certain expenditures become prudent which might otherwise be imprudent. A deductible dollar costs only 48

cents and tax oriented business judgment is an inevitable consequence of this disparity. If a dollar costs only 48 cents, that frequently makes it worth while to do things and take risks which perhaps might not be done if the full dollar cost were incurred.

I used to think that this was bad, and I still do to the extent that it costs smaller and weaker companies more to do these things and take the risks than it does the stronger companies.

However, I am coming around to the view that a high rate of corporate tax is not altogether bad since it tends to stimulate such activities as sales promotion, research and new product development and these activities, in turn, generate jobs and income.

On the other hand, corporate income taxes, like all other taxes, tend to become a cost component. Management is interested in how much will be left for the stockholders after taxes, and they will, so far as they can, fix their prices at levels which will produce a desirable return for the shareholders.

Thus, while the tax may spur employee benefits, and other deductible expenditures of the character mentioned above, thus increasing consumption and investment, it will also tend to increase prices and decrease dividend distributions, thus decreasing consumption and investment.

I conclude that a high corporate rate, providing it is not too high, is probably a neutral factor, that is, it stimulates as much economic activity as it curtails.

Naturally what is too high will vary with circumstances.

In an economy influenced by high defense and other expenditures by the Federal Government, a rate may be tolerable which would not be tolerable were we able to afford, without prejudice to our security, a very materially reduced Federal budget.

The present 52 percent rate—30 percent on the first $25,000 of taxable income—is plainly not unbearable, neither is it comfortable, and I would hope that when tax reduction is vouchsafed us, the corporate rate should not be completely left out in the cold.

Mr. MILLS. Our next panelist is Prof. W. Bayard Taylor, dean of faculty, Claremont Men's College, Claremont, Calif.

Mr. TAYLOR. Mr. Chairman, it is quite apparent that high taxes are unable to prevent the American enterprise system from becoming prosperous once it gets into high gear. Profits before taxes, during the past decade, have increased 123 percent. Cash dividends in the same period have risen by 128 percent and undistributed profits 178 percent.

Taxes, by contrast, have increased only 119 percent. Expressed differently, in the same period that profits before taxes increased from $19 billion to over $40 billion, corporations paid a smaller percentage of these profits in taxes, 49 percent in 1955 as compared with 56 percent in 1945.

At the same time they distributed 25.2 percent of their profits as dividends in 1955, compared to 24.7 percent in 1945, and retained a considerably larger percentage as undistributed profits in 1955—24.8 percent compared with 18.9 percent in 1945.

How was it arithmetically possible for corporations to pay their stockholders a larger slice of their earnings at the same time that they kept a larger percentage for reinvestment? This was accomplished by reducing the percentage paid out as taxes. Less taxes were

paid because corporations were able to increase their deductions. They borrowed and deducted the interest and they took advantage of accelerated depreciation. Annual charges to depreciation were $5.3 billion in 1946 and $11.8 billion in 1953.

As Mr. Leggett, my colleague on this panel, has pointed out, term loans to corporations by banks and insurance companies have contributed to debt financing and the data on corporate securities issued for cash reveals that bonds and notes have far exceeded equity issues.

If company A can and does borrow and company B cannot, or because its management is old-fashioned, does not borrow, A compared to B becomes what Professor Blum in these hearings has called a preferred taxpayer (compendium, p. 251).

Company A is preferred because, even with the same rate of earnings on total assets, it obtains a higher rate of return on equity capital than company B.

Professor Groves says that "the first and least controversial principle of tax equity is that two persons (to which we add that corporations are legal persons) whose relevant circumstances are the same should pay the same tax" (compendium, p. 290).

One of these relevant circumstances is certainly the ratio of earnings to invested capital and it can be argued that equity is violated when a debt-financed person is permitted to pay a smaller tax than his debt-free contemporary.

The logic employed by Professor White in his analysis of rentals for the contrasting cases of the tenant, mortgagor, and clear owner can be applied to the corporation. (Compendium, pp. 358–359.)

White concluded that the deduction of mortgage interest discriminated against the tenant and the clear owner although the gross annual rental was the same for all three. Gross annual rental, it is now appropriate to mention, is a market phenomenon. So likewise is the gross annual income of a corporation.

The test, therefore, of a corporation's ability to pay taxes is the gross annual income (after expenses but before interest and taxes) which the corporation is able to obtain from the property which it employs, whether that property be leased, borrowed, or owned outright.

A law that permits the tax accountant to cross over to the right-hand side of the balance sheet and obtain an exemption award for debt capital is as inequitable as it is illogical.

It is unnecessary to join either side of the argument that taxes should or should not be used to reform the social structure of the economy in order to argue that taxes should not be used to alter the capital structure of the economy.

The deductibility of interest does just that for noncorporate as well as corporate users of economic resources. The financially sophisticated consumer realizes this, and the financially naive have joined or been led into the same practice.

The couple with a $10,000 taxable income that can borrow $15,000 at 5 percent to finance a home pays, in effect 3.75 percent interest. If they finance their $3,000 car on a nothing-down-3-years-to-pay basis and acquire $5,000 worth of furniture and appliances on easy payments at prevailing carrying charges they can deduct $800 more and reduce their taxes from $2,640 to $2,113.

If they live in Corpus Christi, according to the Wall Street Journal, they can show their gasoline credit card when they go to the movies, be admitted and obtain popcorn with no cash outlay.

Economists can still be found, most of whom were educated before 1930 and are therefore uninitiated, who question the stability of a prosperity the current level and continuation of which is dependent upon credit expansion.

Debt, whether it originate in retail salesmanship or Federal deficits, must either be serviced or repudiated. If its service depends upon a level of income that must be sustained by more investment, and if more investment is obtained chiefly by borrowing, the day will come when debtors or creditors or both will be unwilling or unable to continue the process.

The trend that we now experience is encouraged by deductible interest, by accelerated depreciation (a subsidy to investment, as Professor Hansen calls it) and by the artificial averaging of corporate earnings through loss carryovers and carrybacks (Compendium, p. 15).

The present tax structure has served to blur the distinction between equity and debt securities to the possible eventual embarrassment of corporate management. It has led corporations to grow from within, to split their stocks, to pay higher dividends per share.

These higher dividends coupled with inflation, boom psychology, and the wide acceptance of the growth stock shibboleth, have conspired to raise stock prices and reduce their yields in industrial, railroad, and public-utility enterprises.

Mr. Mills. Our next panelist is Prof. E. Gordon Keith, chairman, department of finance, Wharton School of Finance and Commerce, University of Pennsylvania.

Mr. Keith. The corporation income tax, which is currently being imposed at a 52-percent rate on all corporate profits in excess of $25,000 a year, and which is yielding close to $20 billion, can hardly help having a significant impact upon the American economy.

Yet the fact that this very productive levy takes away from the corporations themselves, or from their stockholders, customers, and employees, billions of dollars which might otherwise have been spent on capital or consumers goods means only that this tax is doing what it and other taxes were intended to do—namely, to repress private spending so that the Government can secure the manpower and resources which it needs without raising prices.

To say that the corporation income tax is a repressive tax is, therefore, not to say that it is necessarily a bad tax. But it is appropriate to ask whether we are attempting to secure too large a part of our total tax receipts from this particular levy, and whether some deemphasis of the corporation tax might not make it easier for us to achieve a stable economic growth. And to answer these questions we need to know as precisely as possible what the effects of this tax actually are.

In attempting to determine the effects which a high-rate corporation income tax may be having on the growth and stability of the economy, we are somewhat handicapped by our lack of certainty with regard to the incidence of this tax. We do not know exactly the extent to which this levy is a burden upon the corporation and its stockholders, or

the extent to which it has been shifted forward in the form of higher prices, or backward in the form of lower wages.

At one time most economists were of the opinion that a tax on net income could not be shifted, and that the more immediate burden of the tax rested, therefore, on the owners of the corporations.

Today, this view is regarded as being substantially correct only for firms operating in strictly competitive markets.

It is now generally recognized that firms operating in oligopolistic markets are frequently able to shift at least a portion of their income taxes. Furthermore, to the extent that such firms aim at "standard" or "reasonable" profits rather than for maximum gain, there is a strong presumption that price increases will follow tax increases.

Even in these cases, however, complete shifting is regarded as unlikely to occur.

Although we do not know exactly how the burden of this tax is being distributed at the present time, it seems reasonable to assume that between one-third and one-half of this burden has been shifted forward, and that a considerably smaller part has been shifted backward.

To the extent that the corporation income tax is an unshifted tax, it clearly can have a significant impact on real investment. An unshifted tax, by reducing the expected rate of return on new investments tends to discourage the starting of new enterprises and the expansion of old ones. An unshifted corporation tax also makes it more difficult for growing firms to finance their expansion by means of retained earnings.

Less attention has been given to the effects of a shifted corporation income tax on real investment, although it has recently been pointed out by Professor Lintner that, under certain conditions, "an increase in corporate tax rates may reduce the volume of investment of other firms unable to shift the tax."

The investment-curbing effects of a shifted tax reflect the extent to which successful shifting involves reductions in output, and so reductions in "induced"investment.

Although a reduction in the corporate rate would appear likely to have a stimulating effect on real investment, it would tend to reduce somewhat the stabilizing capacity of the Federal tax system. Because of the sensitivity of corporate profits to changes in the level of economic activity, the present high rate tax has become a rather potent automatic or built-in stabilizer which can be depended on the cushion or dampen the effects of any deflationary or inflationary forces which develop in the economy.

The other taxes to which a portion of the present corporate tax burden might be shifted could not be expected to be as effective in this role.

If it is desired to lighten the impact of the corporation income tax, there are a number of ways in which this could be accomplished. The most obvious move would be to reduce the present rate. There is a good deal to be said for getting this rate down below the 50-percent level; but a sharper rate reduction could be objected to on the grounds that this would result in undistributed profits being taxed too lightly in relation to distributed earnings.

So long as there is reason to believe that a substantial part of the corporation income tax is being borne by stockholders, a strong case

can be made for reducing the tax on distributed profits. This could be done by extending the dividend-received credit which was introduced in the 1954 act, by granting a partial deduction for dividends paid out by corporations, or by adopting the so-called withholding approach currently being used in Great Britain.

Although there are disadvantages associated with all three of these methods, the second and third would appear to be preferable to the first if the unburdening of distributed corporate profits is to be pushed very far.

Mr. MILLS. We thank each and every one of you for the splendid summaries of your presentations appearing in the compendium.

These hearings, as you know, are addressed to determining economic principles which will guide the Congress in formulating tax policy for economic growth and stability.

The corporate income tax, which we are considering this morning, is the second most important element of the Federal revenue system from the point of view of tax yield. It has been continually referred to by panelists who have appeared so far, some urging prompt reduction in the tax, some arguing that the tax has imposed no unduly large deterrent to economic growth.

This morning, we would like to examine this tax in some detail to see if we can determine which of its features are important in the light of our economic growth and stability objectives.

I would like to address my first question to Professors Taylor and Keith: One of the principal questions I believe raised in connection with the corporate income tax is the impact of the tax on corporate financing by internal funds, and by issuing equity or debt instruments. Have there been any significant changes in the pattern of corporate financing in recent years, as among these methods?

Professor Taylor?

Mr. TAYLOR. Yes, Congressman. The evidence is available that corporations have gone increasingly into debt financing in order to sell their debt securities on a market which was not too responsive; the bond market has been unwilling to take what corporate management has considered reasonable yields and bonds at par and corporations have tended to blur, as I have said in my paper, the distinction between debt and equity financing by offering bonds with warrants attached and the convertible feature.

There is more debt financing now. I do not have the total figures—than there was 10 years ago.

Mr. MILLS. Professor Taylor, at an earlier panel, Mr. McCracken, whose paper you perhaps have read in the compendium——

Mr. TAYLOR. I have.

Mr. MILLS. Said that since 1945, I believe, the period between 1945 and 1954, at least, the capital structure had changed not at all, that is on a percentage basis. In other words, in 1954 the same as in 1945, 75 percent was derived through equity and 25 percent through debt.

You are not referring, therefore, I assume, to an increase percentagewise. You are referring to an increase in each dollarwise?

Mr. TAYLOR. I am referring to the percentage ratio, Mr. Chairman.

Mr. MILLS. You disagree with Professor McCracken.

Mr. TAYLOR. I cannot support it with totals. I have read recently of the Textron Corp. refinancing. I am sure the evidence could be

martialed to show that corporate management has taken advantage of the deductibility of debt interest. I know it can be cited for corporation after corporation. I know that the statistics from the Securities and Exchange Commission on new issues show a growing preponderance of notes and bonds over equity issues. How this could fail to affect the total corporate structure of the country I do not see.

Mr. MILLS. Professor Keith, do you agree with the conclusions of Professor Taylor?

Mr. KEITH. I would simply like to point out that whereas Professor Taylor's own figures here on page 264 do indicate a high proportion of bond issues to stock issues, his figures also show a very large increase in retained earnings, since 1945, which is equity capital. I would suggest that possibly we could reconcile Mr. Taylor's and Mr. McCracken's differences of opinion here by taking account of the retention of earnings. We have maintained very much the same capital structure, even though the new issues may be predominantly bond and notes rather than common stocks.

I would also like to suggest, before we lay all the blame on the tax structure, that until recently the last decade has been one of relatively low interest rates. Firms have floated debt issues in order to take advantage of this. The extent to which corporations have been induced by low interest rates to secure funds through the sale of bonds and the extent to which tax savings have encouraged debt financing is something which I think is very difficult to determine. But I think both factors have played a part.

Mr. MILLS. Professor Taylor?

Mr. TAYLOR. I accept his supplementation with respect to the increase in equity resulting from retained earnings, of course.

I would like to have those added to any such ratio which I do not have at hand as might be finally determined. I think that is correct.

Mr. MILLS. I understand that that is what Professor McCracken had in mind also. That is the reason I was wondering if we could get some objective evidence, if you have any at all, that will support your conclusion.

You remember Professor McCracken gave us some evidence to support his conclusion of 75 percent equity and 25 percent debt; the figure in 1954 being the same percentagewise as the figure in 1945.

I understood you to say you did not have any full actual figures to bear out your conclusion?

Mr. TAYLOR. Right.

Mr. MILLS. Are they obtainable?

Mr. TAYLOR. Yes; here is what I would do, if I had not encountered this point after I came to Washington. I would have gone to some compendium that would have shown me a consolidated condensed total balance sheet for American corporations in several different fields, say, railroads, public utilities, and industrials and compared the two righthand sides of their balance sheets for 1945 and 1955.

Mr. MILLS. Professor Taylor, you are saying, I presume, then, that the corporate income tax in the last 10 years has influenced the method of financing?

Mr. TAYLOR. Yes.

Mr. MILLS. And that it has brought about a greater percent of debt compared to equity financing?

Mr. TAYLOR. May I restate your statement of my statement, Mr. Chairman?

Mr. MILLS. Yes.

I am asking it as a question.

Mr. TAYLOR. It has brought about a greater use of outside financing in debt financing.

Mr. MILLS. That is the corporate income tax that has done it?

Mr. TAYLOR. It has had an influence, a large influence, sir.

Mr. MILLS. What are the other influences in your opinion?

Mr. TAYLOR. That have affected corporate financing?

Mr. MILLS. Yes; that have caused the increase you referred to in debt compared to equity.

Mr. TAYLOR. Offhand, I would not add any.

Mr. MILLS. You would attribute all them to the corporate income tax.

Mr. TAYLOR. Not necessarily. I just do not have at hand other factors at this moment that might have had that influence.

Mr. MILLS. To the extent that the corporate income tax has influenced methods of financing, can that be attributed to the rate or to specific provisions of the tax structure affecting corporations?

Mr. TAYLOR. The emphasis which I have made in my paper is the interest deductibility, of course, as the primary influence.

Mr. MILLS. Rather than the rate?

Mr. TAYLOR. Rather than the rate.

Mr. MILLS. What features if any of the corporate income tax would management take into account in reaching decisions with respect to internal or external financing, deficit versus equity financing?

Is it this deductibility of interest paid out?

Mr. TAYLOR. It also takes into account as it always has of course, the leverage effect upon equity of employing what the Englishman calls "cheap capital." If I can borrow at 3 percent and make 8 percent, I can earn more on my net worth.

Mr. MILLS. Professor Keith, do you agree with what has been said up to this point?

Mr. KEITH. Yes; I think I do.

Mr. MILLS. Is the method of financing used by corporate enterprises significant from the point of view of economic growth and efficient use of resources?

Mr. TAYLOR. Yes; it is significant; yes, sir.

Mr. MILLS. Do you agree?

Mr. KEITH. I would agree; yes. Too heavy debt structure in corporations tends to make them somewhat more vulnerable to fluctuations. I don't think writers are as dogmatic about this as they used to be. There was a time when it was generally agreed that corporations should never have any long-term debt unless they were public utilities or were certain of having a stable income year in and year out.

Today, I think a lot of our large corporations are from this standpoint very much like utilities.

They are pretty well assured of a minimum amount of income. Consequently debt can be justified in their capital structure. But too much debt does tend to make the economy more vulnerable to a recession.

Mr. MILLS. In the future, would you expect the individual dividend received credit to have an important effect on methods of corporate financing?

Mr. KEITH. You are asking me this.

Mr. MILLS. Of you.

Mr. KEITH. I do not think that the dividend received credit, if you are talking about the present 4-percent credit, will have a very significant effect. I can see that it will result in some tax savings, for wealthy dividend recipients, but by and large I doubt whether this credit is a major factor in determining what the investment policies and investment decisions of these individuals are. So that my answer would be—relatively little so far as the present credit is concerned.

Mr. MILLS. In other words, you are saying that the retention in the future of the dividend received credit provision would not lessen the percentage of debt versus equity?

Mr. KEITH. Well, this raises a question as to whether the credit makes equity financing more attractive to the people who are willing to buy equities. Now if, as Mr. Taylor points out, this provision results in rising stock prices it would undoubtedly make it easier for firms to meet their capital needs through sales of stocks, rather than through sales of bonds, as it did during the twenties.

It would affect the balance, but how significant this will be in terms of total financing I am not prepared to say.

Mr. MILLS. Is it the best way to do this?

Mr. KEITH. I am inclined to doubt whether this is the best way to relieve the burden on distributed profits. If you push this approach very far, you get into certain difficulties. This is only one approach to the problem of integrating the corporation and individual income taxes.

Mr. MILLS. Professor Keith, Professor Taylor, there is no doubt in my own mind that those on the Ways and Means Committee who supported the proposition initially did so because they felt from information that came to them from the staffs of the Treasury and other places that the dividend received credit would tend in the direction of producing more equity capital, and thereby alleviate the necessity of as much debt financing in the overall structure.

Now, I have asked the question because I wondered whether, on the basis of your studies, it had been possible for you to observe yet whether the provision had actually gone in the direction of the desired goal.

Mr. KEITH. Well, I haven't made a study of this particular point.

Mr. MILLS. At the moment, Professor Keith, I want to lay aside the indirect benefits that might be derived by those who own the stocks. I am thinking solely now in terms of the question of corporate financing.

Has this provision tended to obtain the objective that was desired by those who supported the provision in the committee?

Mr. KEITH. Let me say, first, that I haven't made any detailed study of this, but in any case I think it takes time for this sort of provision to influence the thinking of investors so that it affects their actions. In the short space of time that has passed since this provision went into effect, I would not expect to find that it had produced much in the way of results.

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Mr. MILLS. How would it be calculated to produce the results?

Mr. KEITH. It would affect, I think, the tone of the market. One gets a feeling of a little less burdensomeness if one buys equities now than would have been the case before. This presumably would increase the flow of funds into equities. Some people have attributed some of the rise in the stock market during the last year or so to this change in the law.

I have a feeling that other factors have played a much more important part in this rise.

Mr. MILLS. A mere rise in the stock market would not indicate in and of itself, would it, that corporations had changed methods of financing?

Mr. KEITH. No. This would merely be an assist, as I pointed out before. The choice between equity and debt financing is, I think, influenced in part by the relative cost of funds and when the stock market is going up it becomes relatively cheaper to secure funds through equity financing.

We had that demonstrated, I think, back in the twenties when corporations did a lot of equity financing during the boom market.

Mr. MILLS. Now, Professor Taylor has said this morning that he thinks at least that the deductibility of interest in existing law may well have had some influence upon the increase of debt—is that what you said?

Mr. TAYLOR. Yes.

Mr. MILLS. As a method for financing corporations. What is there about the dividend-received credit from the viewpoint of corporate management that might equalize the advantage of the interest deduction?

Mr. KEITH. Nothing directly.

Mr. MILLS. To corporations.

Does it then offer corporate management any inducement to change from debt to equity?

Mr. KEITH. Only insofar as it affects the tone or the level of the market, I would say.

Mr. MILLS. Then it would depend upon whether or not a 4 percent credit would be sufficient to affect the tone or level of the market.

Mr. KEITH. Yes.

Mr. MILLS. And you have raised the question, I think, from what you have said, as to whether or not that is large enough percentage credit to do that?

Mr. KEITH. Yes.

Mr. MILLS. So that if the present dividend-received credit is not large enough to affect the tone of the market and the level of the market, then it may not be affecting the corporate decision as to whether or not to go the debt route or equity route, in capital structure.

Mr. KEITH. That is right.

Mr. MILLS. If it doesn't do that then it only results in a benefit to the recipient.

Mr. KEITH. Yes.

Mr. MILLS. Do you agree with this, Mr. Taylor?

Mr. TAYLOR. From a purely financial point of view; yes. There is another consideration that I would like to mention, and that is that

the wider distribution of stock is a matter of movement to corporate management. If the smaller purchaser of stock can be induced into the market, in response to this forgiving of dividends received, it makes for a wider distribution and may lay the corporation open to less danger when proxy flights develop, of which we have had a recent rash as far as corporation point of view is concerned.

The splitting of stock as equity has increased from retained earnings, is another step in that direction; it has lowered the price of the stock.

It is very difficult to find a stock today that sells as high as $100. In the olden days of my youth, 20 years ago, $100 stocks were plentiful upon the market. They had been reduced to bring the small investor into the market, and the more small investors you have, the more mailing in of proxies instead of the appearance at stockholders' meetings of the small holder, either by representation or in person.

This is evidenced somewhat by the pride with which the management of the New York Stock Exchange pointed out that they had been able to absorb the late decline in the market in good order—a very orderly absorption of the selling that took place during the break at the end of September. Their figures evidence what has occurred with respect to equity ownership in America.

A large percentage of those orders were odd-lot orders, orders which had to be bulked as they came in from many small sellers. The small buyer, the 10-, 20-, 30-share lot purchaser has been coming into the market in increasing numbers in the last few years, thanks to a number of reasons—not thanks principally, I do not want to be misunderstood—to the corporate income tax.

There are other things that have brought John Q. Public into the securities market.

Mr. MILLS. How significant, actually, since you raised the point, is this dividend-received credit to the small taxpayer, or small investor?

Mr. TAYLOR. I think of relatively small significance.

Mr. MILLS. It, in and of itself, perhaps, is not enough, really, on the basis of the present percentage of credit to attract that individual to buy stock that he otherwise would not?

Mr. TAYLOR. Right.

When you run it up into the high brackets, you have to run it up a long way to get a significant result; there aren't too many high-bracket taxpayers and I don't know how many, but there certainly aren't many in the 91-percent bracket who are buying securities on a large enough scale to obtain the benefit of the 45-percent improvement in total dividend income retained after taxes.

Mr. MILLS. Don't be misled by the questions I have asked as to my own views on this matter of equity versus debt in corporate capital structure. I naturally would like us to have as much equity available as we could have available at any one time because I prefer that form of capital growth, as I am sure all on the panel would prefer that form of capital growth. I have had these questions about the dividend-received credit for some time, because I have never believed that it is the best way to accomplish the stated objective for which it was enacted, namely, to provide inducement to greater equity financing than debt, and I was interested in Professor Keith's observation that there were perhaps better ways of accomplishing this objective, and

I hope that on the basis of your paper, there isn't too much difference really between your thinking of how it should be done and my own.

Unless one of the other members of the panel has something to say at this point on the basis of the questions so far, I want to go on——

Mr. RUDICK. I am an amateur in economics compared to Professors Keith and Taylor, but I have some beliefs on the subject. In addition to the deductibility of interest and the fact that interest rates were low, I think one factor that contributed to the high ratio of debt compared to equity financing was that equity prices until the last year and a half were relatively low.

Professor Keith adverted to it later on but not in his original statement. I think that was one important factor, that companies couldn't go out and sell their equities for enough to make it worth while. It was much better for them businesswise to issue debt at a low rate, the interest on which could be deducted.

If I understood Professor Taylor correctly, he suggested that perhaps the deduction for interest ought to be disallowed, and if that is so I think it is utterly impracticable. I don't think you could carry on business without an allowance for the deduction for interest. If there is going to be any redress for the differential between debt financing and equity, the way perhaps to do it is to allow deduction for dividends as well as for interest.

That means an undistributed profits tax, and most businessmen throw up their hands in horror at the undistributed profits tax and yet, I don't think it would be too bad. I suggest that if, when we had the undistributed profits tax it had supplanted the income tax instead of merely complementing it, it might have had a different fate.

Perhaps a compromise position in between is to allow deduction for dividends on preferred stock. That would go part of the way.

Mr. MILLS. That is a debt obligation.

Mr. RUDICK. Much preferred stock is pretty much the same as a debt obligation.

Mr. MILLS. I think you made a very constructive suggestion. Mr. Silverstein?

Mr. SILVERSTEIN. I have very little to add, except that I would also think insofar as balancing out the relationship between debt and equity from the corporate standpoint, the deduction for dividends on stock would be much more able to accomplish the objective than a dividend credit for the shareholders which I have viewed one of the objectives there was to relieve the double taxation generally.

Mr. MILLS. That was not the reason that the Committee on Ways and Means accepted it, according to the statement of those who voted for it in the Ways and Means Committee.

I think I stated the real purpose.

Mr. SILVERSTEIN. To achieve that purpose, it seems to me a much more direct method would be a partial deduction for dividends paid on some stock or such as a limited class which Mr. Rudick suggested.

Mr. MILLS. We have heard a lot of testimony about the incidence of the corporate income tax. Some panelists have maintained that the tax is passed on to consumers in the form of higher product and service prices. Others maintain that the burden of the tax rests on the shareholders. Others argue that it is passed back to productive services used by the corporation.

Would you gentlemen express your views about the incidence of the tax? What is the significance of these various incidence notions for Federal tax policy?

Mr. KEITH. I have already commented on that.

I am not sure I can say precisely what the incidence is. I am not sure that anybody can. I believe John Lintner, who you are going to have here this afternoon has been doing some work on this problem.

Businessmen have always maintained that they pass the tax on. Economists have usually taken the position that insofar as this is a tax on net income, it cannot be passed on.

This difference of opinion was perhaps brought out most sharply in the Colwyn committee hearings back in 1927 in Great Britain. Since that time, however, I think the economists have changed their position somewhat. There is some evidence that corporate pricing is not always based on the principle of profit maximization. If you assume that corporations were not maximizing profits before the tax was increased, then there is no reason in theory why they couldn't raise their prices after the tax increase. Some people maintain that a large number of corporations, and particularly the big ones, set prices so as to maintain standard profits or what they regard as reasonable profits. In these cases, prices are likely to be affected by the level of tax rates.

On the other hand, the dogmatic position that businessmen sometimes take, in insisting that they can and do pass on the tax under all circumstances has always seemed to me too extreme. They may think they do it, but if sales lag as a result of this action they are likely to reverse their price policies. I think you will find that most people who have had to make some assumption concerning the incidence of their tax have concluded that between 30 and 50 percent of the tax is now being passed on in the form of higher prices, and that perhaps as much as one-eighth is passed back in the form of lower wages. Nobody feels very certain about this but they seem to be the best assumptions for the time. Under less buoyant circumstances corporations might not have been able to pass on as much of the tax.

I think we have to recognize that during this period when the rate has been going up, circumstances have been about as favorable as we could imagine for shifting the tax.

What would have happened under less inflationary conditions is something else again.

Mr. MILLS. Mr. Taylor?

Mr. TAYLOR. I would like to add that what to do about a tax is only one of the problems confronting business management. It may be able to absorb it by doing other things within the plant, by increasing its turnover or increasing efficiency by one means or the other.

In these days of lush business, more businesses than ever are admitting that internal organization and operation are inefficient and if they are inefficient that is an opportunity. You can sometimes keep the tax from the consumer by lowering costs otherwise, and even though the businessman be wrong—and I am not saying that he is entirely in thinking that an income tax adds to his costs he has other ways of meeting his cost problem.

Mr. MILLS. Do you have any comment, Mr. Rudick?

Mr. RUDICK. I agree generally with what Mr. Keith said. I would just add that the degree to which the tax can be shifted would vary with the industry or with the position of the individual company.

If the company had very little competition, and providing it didn't pass the point of diminishing returns it could add the tax or at least the greater part of it.

On the other hand, if it was in a very competitive industry the opportunity to pass it on would be less. If, in an industry where labor is strongly entrenched, it is probable that very little of the tax is shifted to labor, but where labor is weak, some of it may be. I don't think you can generalize. I think it varies from company to company. All you can say is that the tax is borne by stockholders, and by labor and by supplies and customers and the degree to which each bears it will vary.

Mr. MILLS. Mr. Rudick, I was interested in a statement by one of the earlier panelists in answer to a question I posed at that time, that a reduction in the corporate tax from 52 to 50 percent might affect product prices in a downward direction. I had asked him what he thought corporations might do with that tax savings, and he gave me two things that he thought they might do. Then I asked him the question if it were possible at all that any of that reduction would be reflected in decreased prices and he said some might be.

What would be your opinion?

Mr. RUDICK. I would doubt whether any significant part would be reflected in decreased prices.

Mr. MILLS. Mr. Silverstein, do you have any comment on the original question?

Mr. SILVERSTEIN. I have no comment.

Mr. MILLS. I want to ask you a question, and I am sorry Mr. Tarleau has been detained this morning because I wanted his opinion on this question, also.

You and Mr. Tarleau, I believe, in your papers for the compendium, suggest that sections 381, 382 and 269 require some revision.

Is that your opinion?

Mr. SILVERSTEIN. Yes. I think so. I think study in that area would be very fruitful. Those sections, I believe, deal with, generally, with the transfer from one corporation to another of certain tax attributes, particularly the net operating loss carryover.

If one could operate for a year and has losses, if it is absorbed by another company or in a merger, or if the loss company is purchased, the acquiring company may obtain some benefit of the consequences of the previous history of the absorbed company.

Mr. MILLS. The Ways and Means Committee had in mind, in writing the original provision in the 1939 code, section 122, which is now 172, in the code of 1954, that the provision would be an averaging device to permit businesses which may have alternating profits and losses a tax position comparable to a business which has stable profits over the years.

Is that your understanding of what the section might do?

Mr. SILVERSTEIN. Certainly that is the basic purpose of the original, that is, of the section which gives the one company—speaking of just one corporation—the right to treat more than 1 year as an economic unit rather than to be hide-bound by the annual accounting concept to say they have a loss one year and profit the next.

We cannot offset one against the other and lump them together.

Mr. MILLS. I have found myself having difficulty agreeing with you and Mr. Tarleau—and here he is now.

Come right in, Mr. Tarleau—in the suggestions that we should permit unrestricted traffic in net operating losses.

I have in mind the following type of example, on which I would like your comment:

Can it be said that X is encouraged to enter a risky enterprise by tax policy which permits Y to utilize the losses incurred in the business if X gains profits of a totally unrelated business which may be completely free from risk?

It occurs to me that X is given an incentive to continue the risk of business far more by tax policy which forces him to retain an economic interest in any loss, which may be incurred in the operation of his enterprise.

Mr. SILVERSTEIN. Incidentally, Mr. Mills, before I comment, I have not taken a position in my paper similar to Mr. Tarleau about that, but however I have some feeling about the subject that is not too different from his.

Mr. MILLS. Let's discontinue then on the question and let Mr. Tarleau have 5 minutes to give his summary paper, if he cares to at this time, and then I will direct a question to him.

We appreciate the fact you could be with us this morning, Mr. Tarleau.

Mr. TARLEAU. I thank you, Mr. Chairman. I appreciate your courtesies in allowing me to appear at this rather late moment.

Mr. Chairman, my purpose is to describe some of the law affecting the transfers between taxpayers of net operating loss carryovers, with particular reference to those aspects which affect business decisions about mergers and other corporate acquisitions.

While I have seen no economic or statistical studies in point, I have concluded, both from my view of the law and my own experience, that tax losses, transferred or otherwise, play a negligible part in the merger movements as a whole.

Let me expatiate on that for just a moment: that in any given individual case, the tax position of either the acquiring corporation, or the acquired corporation, or the shareholders, will probably play a significant role, but speaking of the complete picture of the further concentration of economic power through mergers and consolidations, it is not my belief that the tax losses transferred or otherwise play a substantial part.

Finally I briefly suggest reforming the policy of the law on loss transfers.

The basic provision for net operating loss deductions in section 172 of the Internal Revenue Code of 1954—I have only 5 minutes and I want to summarize as much as I can to reach the main points.

We now have a 8-year averaging device with the 2-year carryback and the 3-year carryforward.

Mr. MILLS. Five-year carry forward?

Mr. TARLEAU. Yes, giving us the 8-year averaging device.

In my opinion the carryover provisions are good tax legislation, because they have the effect of equating taxable income with the real economic results of an enterprise.

I think it is the rightness of the averaging principle which has caused Congress to extend the carryover and carryback periods from time to time, and to eliminate in the 1954 code certain artificial limi-

tations on the survival of loss carryovers in corporate reorganizations.

I think personally that there has been a great deal of misunderstanding about the importance of tax losses in corporate acquisitions.

There are certainly a few notable examples of situations where a corporation has been assisted in making an acquisition of the business of another corporation by reason of having suffered losses which can be set off against future profits.

The limited tax saving available either provides additional funds to pay for the acquisition, or makes the financial prospects of the buyer more attractive to the sellers if they are depending upon its credit or stock for payment.

The acquiring corporation in cases of this kind is essentially looking for a source of income to recoup past losses.

Insofar as the tax loss carryover statute is concerned, it makes no difference whether the buyer generate income out of its own business, or through the acquisition of other assets or businesses.

In either case, the desirable averaging principle of the carryover provisions operates to assist the corporation which suffered the loss in obtaining some recoupment.

I think the actual significance of transactions of this kind in the merger movement is very small. Many corporations with substantial tax losses are not sufficiently viable from the business point of view to carry through a program of expansion with or without the limited tax benefit of the carryover.

Moreover, when considering the use of carryovers transferred or otherwise in corporate expansion, it is well to keep in mind their limited duration.

The 5 year maximum limit imposes a very exacting time schedule on any one who proposes to base an acquisition program on tax savings which come from the use of a loss carryover, particularly when it is dependent upon the future earnings and future prospects.

Of course cases of the kind just discussed may or may not involve tax loss positions which have been transferred from the enterprise in which, or the owners by whom, the losses were suffered.

I believe that transfer of tax losses have had an even less significant effect on the merger movement.

This is because superimposed upon the carryover principles of section 172, we have in the new tax law a complex and erratic set of provisions which modify the transferability of tax loss carryovers, and then I have described in my main paper what those limitations are and I do not believe it is particularly helpful to go over those.

I have given them in as much detail as I think this committee would be interested.

The point that I made in my paper with respect to the limitations on the right of free transferability of operating loss carryovers is that there are a complex set of provisions governing different types of acquisitions which may differ in form rather than in substance, but the difference in form may lead to drastically different tax results.

Moreover, I think the provisions do not have a consistent policy with respect to the philosophy or purpose of the allowance of these tax-loss carryovers.

In certain instances in the statute, the prohibition against the transfer of tax-loss carryovers is conditioned upon the state of mind, the purpose, the subjective intent of the parties entering into it and con-

sequently we can have two transactions with the same economic results, but with different personal motivations, other motivations, which may create different tax liabilies.

It seems to me that whatever one's philosophy is with respect to the position of tax-loss carryovers and carrybacks, in the internal-revenue system, these provisions need a complete reexamination and a more consistent philosophy should be applied throughout the code with respect to this particular type of tax allowance.

I had mentioned in my prepared statement, which has been included in your printed record, some further reasons why I believe that the ideal situation from my own point of view, if the revenue is permitted, would be free transferability.

I caution, however, in my prepared statement, revenue needs may create the necessity for some restrictions on the transferability of these net loss carryovers, and it is in my opinion the need of the revenue rather than any basic philosophical requirement that may necessitate a restriction on the free transferability of net loss carryovers.

Mr. Mills. Does that complete your statement?

Mr. Tarleau. Yes, sir.

Mr. Mills. Mr. Tarleau, as you were entering the chamber, I was in the process of addressing a question to Mr. Silverstein, because of the thought that you and Mr. Silverstein had jointly made certain observations, which he says I have erroneously attributed to his paper.

I do recall distinctly that you referred to the necessity—that is, in your paper and here this morning—for revision of sections 381, 382, 269, as well as of section 172.

I can't agree with you more heartily in your observation of the desirability of revisions of 381, 382, and 269.

However, I find myself at a loss to understand the logic—and I know you are always logical, so it is my fault—of your point with respect to 172, in which you are actually suggesting that we permit unrestricted traffic in net operating losses.

As I remember the intention of the Ways and Means Committee it was that 172 and its predecessor, 122, serve as an averaging device to permit businesses which may have alternating profits and losses a tax position comparable to that enjoyed by businesses which have stable profits.

Therefore, I ask this question: How can it be said that X is encouraged to enter a risky enterprise by a tax policy which permits Y to utilize the losses incurred in the business of X against profits of a totally unrelated business which may be completely free from risk?

It occurs to me that X is given an incentive to continue the risk of business far more by tax policy which forces him to retain an economic interest in any loss which may be incurred in the operation of his enterprise.

Mr. Tarleau. Your question, Mr. Chairman, is a very stimulating one, because it suggests a whole line of inquiry to which I have adverted in my prepared statement.

One of the things that has puzzled me—and I say this with a great deal of sincerity—in working through these provisions and in considering this whole problem is, What is our philosophy with respect to the carryover and carryback provisions?

Is it essentially one of recoupment, in which the corporation is entitled to recoup out of its future earnings, losses previously had, and entitled to have a refund of previous taxes and profit years out of current losses?

Is it a recoupment idea, or an averaging idea, which has in it the recoupment philosophy?

If that is so that is one way to look at the situation.

On the other hand it is quite conceivable that we could have a philosophy with respect to net operating loss carryovers, and because I suggest that that is a possibility, I do not for a moment want to be in the position of advocating it, but I can understand that it could be a philosophy, that in a business—and by a business, we may mean any of a number of things.

I suggest for the moment that by a business we mean an enterprise of a particular kind in a particular economic sphere, with risks and hazards of the customers, the equipment and the capital necessary to maintain it in that sphere and we may say that our policy is that the losses and the income over a period arising out of that economic activity should be averaged, and the purpose of that might be any of a number.

One of those you have suggested, namely, to encourage persons to enter into risk enterprise where we have an initial period of losses and gains would only be realized in the future.

That may be. Unfortunately, from a philosophical standpoint, if that is your philosophy, our statute is not aimed at that.

If it is aimed at that it certainly has no indication of it in the four corners of the statutes, because we are looking at it, not from the point of view of averaging an enterprise, separate and apart from the corporate form in which the enterprise takes place, but we are dealing just with corporations themselves, no matter in what business the loss was sustained, or what future business they go into to recoup their losses.

I would find a great deal of difficulty in averaging gains or losses out of a particular enterprise in any corporate form. I think that would be an exceptionally difficult thing to do, if one decided it was a good thing to do, but once one departs from that idea that a business means what a person ordinarily thinks it means—I am in the furniture business and my losses in the furniture business can only be taken against my gains in the furniture business, once we depart from that it seems to me speaking colloquially a tax loss creates a deferred asset which you use as a tax credit against any other type of business you go into and if you are not able to go into it, you are forcing persons to treat it as a deferred asset and deal with it as such.

My complaint against the statute is that, in some instances, you may treat it as a deferred asset, and in other situations you may not and have very frequently, the privilege of treating it one way or the other depending upon form rather than substance.

Mr. Mills. Mr. Tarleau, I hasten to agree with your observation that it is a little difficult to determine what policy exists from the reading of some of these sections that we are referring to and I do not criticize anybody in that connection, because you and I realize fully that they are very technical phases of the tax law, and that it is pretty hard under any and all circumstances to say in tax law just

exactly what you want to say in very simple language, so the policy can be easily determined.

I agree with you completely in that observation, but I still have difficulty with your thesis.

Let me put it this way, and see if you have thought of this aspect in reaching your conclusions:

The recoupment realized by sale of the tax loss bears little or no relation to the objectives that I think were sought in section 172, because it permits the profits of an unrelated business to be averaged, not against the earnings of the person taking the risk but against a sure thing perhaps with little benefit to the original risk taker.

Mr. TARLEAU. May I talk just to that point?

That is so much part of the thing that I have considered, Mr. Chairman.

You started your statement—first of all, let me say that it is not only the complexity of language because language is complex and has to be—as an old legislative draftman I sympathize with persons who have to draft statutes.

I think it has to be complex, and where we want to be precise and particular it has to be that much more complex.

My criticism is not only that at times I think it is unnecessarily complex, but I do not believe the philosophy has been thought out.

Let us take the situation that you speak about.

Corporation X is engaged in the business of making radios, and it has lost a great deal of business in making radios.

That corporation has, let us say—it is a public company—over the years it has lost quite a good deal of money in the radio business.

The directors decide that with this large net loss that they have accumulated over the years, that that corporation should not continue in the radio business. It was a business that they evidently are not able to prosper in, and they decide to go into the steamship business.

Now that corporation goes into the steamship business. Is the philosophy of section 172—forgetting whether it carries out its philosophy correctly—is its philosophy such that we should permit that corporation to go from the radio business, with its losses, into the steamship business, with its profits, or its hopes for profits?

That is the first question that comes to my mind.

Certainly that corporation, with a credit for taxes—the ability to earn in another endeavor, tax-free income—is, in a sense in a better position to acquire another business than a corporation that does not have that net loss carryover.

It paid for it by having that loss. My big point is if anybody else wants to get it they should pay that corporation for it as much as the market will bear, if we believe that the correct philosophy is to disregard the business venture itself, and merely look to the corporate form.

Mr. MILLS. Mr. Tarleau, let me ask it this way if I may: I am not endeavoring at all to embarrass you, you understand. I am merely trying to understand the best I can the purport of your paper in the compendium.

I have no objection at all to the averaging of losses for a business, but I raise the question about this spread of the use of the loss as advocated in your paper.

Let me put it this way: If the person who realized the loss retains an economic interest in the loss by using it in another business, to that extent he has received the incentive Congress intended, but then how is he being encouraged to stay in business by permitting his sale of the loss to another individual?

He is going out of business, isn't he, but the Congress is trying to encourage him to stay in in some form.

Mr. TARLEAU. Well, if it was Congress' intention, which is another possibility, one which I frankly did not treat in my paper, because I had not considered it—if it was Congress' intention to give the net loss carryover treatment—I did mention it.

I did mention it. I am not as dull sometimes as I think I am—I did concede that it was possible that Congress might have intended the entrepreneurs forgetting the corporate form completely, the persons who actually risk the capital in the first instance in that situation to the beneficiaries of that averaging situation, and that I could understand as another policy, but the statute does not have that policy.

Incidentally that policy would be a difficult one to carry through. It would be a difficult one to carry through, particularly with public companies. It might be done with closely held companies. We would have all the usual family attributes and problems so that we would give him the privilege of saying that he and his family at least are the economic unit that created the risk that ruled in the loss.

We would have a great deal of difficulty in doing it, but I freely concede, Mr. Chairman, that a possible rational philosophy would be that the only beneficiaries of a net loss carryover in the case of a corporation, which is after all what we are talking about, are that group of stockholders or substantially only that group of stockholders who have maintained their capital position in that corporation which have the loss.

I submit to you, Mr. Chairman, that that is not any philosophy which one can glean from sections 269, 381, and 382, because as a matter of fact it says just the opposite.

It says you can sell out your loss to somebody else that has a good business reason for acquiring your corporation provided the other person stays in that same business.

He can add other businesses to it as well.

Consequently, looking at it from the standpoint of a commentator trying to glean the intention of Congress from the provisions themselves, it is difficult to find that particular philosophy in the statute.

Mr. MILLS. Mr. Tarleau, I have to agree with you that the section we are referring to can be improved in draftsmanship.

Mr. TARLEAU. In philosophy too, wouldn't you think?

Mr. MILLS. Not to the extent of extending the philosophy, as we intended it at least, of the sections to this indiscriminate traffic in losses, the sale of losses.

I would not go that far, I do not believe.

I would like to know whether there is any other comment on this point by other members of the panel. I want all members of the subcommittee to have an opportunity to interrogate the panel.

Mr. SILVERSTEIN. I believe as Mr. Tarleau said, the loss carryover attributes of taxing the corporation as an entity as distinguished from stockholders.

The situation which you quoted, one group of owners of the business selling to another group, the carryover, and that being the item bargained for applies only in those situations where it is possible to designate one group, the original economic investors as owning the stock of the corporation and possessing the equity and as having sold that to another group. The difficulty with that concept appears in those cases of publicly held companies or any other corporations, where stock is changing hands constantly.

It is impossible to say that one group of owners, as distinct from the corporate entity itself, owns or is entitled to the attribute. You must necessarily look to the corporate entity. It is he only way of saying that the corporation irrespective of who the owners at a given moment may be, has suffered losses in the past and is therefore entitled to recoup those losses in the future. The answer is that you must distinguish between those privately held companies, where the shareholders are the managers and the owners, and those companies where the corporation exists as apart from the shareholders.

I think what you are talking about, the traffic in the carryovers and more rigid restrictions against it may apply in those cases, where one group of shareholders has maintained an interest over a period of years and is then attempting to bargain that carryover as one element of sale.

Mr. MILLS. Mr. Silverstein, I want the record to be very clear in what position I am taking as a result of the questions I am asking.

I am not objecting at all to the policy of section 172.

I am objecting to the manner in which sections 381, 382, and 269 carry out that policy, that intention of the Ways and Means Committee.

Mr. SILVERSTEIN. They certainly are not uniform in their application. The effect of their presence in the statute is to inhibit many mergers and other melding of various corporate enterprises where the carryover is only one feature and where parties to the transaction expect to maintain it, but because of the erratic application of these sections, the parties may be in the fear of using it.

Compare that case to the case where the parties bargain for the carryover and it happens to be the sole motivating force in the transaction. Here through astute planning it is possible to avoid the provisions of the section. There is no doubt something must be done in this area.

Mr. MILLS. Mr. Rudick?

Mr. RUDICK. I do not often disagree with Mr. Tarleau but I do in this proposal to allow unrestrained transfer of tax losses. It rubs against my grain to have the tax law subsidize the traffic in tax loss. The purpose of carrying losses backward and forward, as you expressed it, was so that the taxpayer in business, no matter what business and whether individual or corporate, whose income is fluctuating losses in some years and profits in other years will be equated with someone else in business whose income is stable.

I do not see how nonrestricted transfer of losses in any important way furthers that purpose.

Mr. MILLS. Mr. Taylor?

Mr. TAYLOR. May I introduced a traditional note by pointing out that an important provision in the corporate charter is the purpose

clause, and it used to be that when a corporation departed from the purpose for which it was organized, ultra vires action could be brought by stockholders or creditors. To go into a new line, in order to buy a tax loss, is to blink at that traditional purpose.

I am indebted to Mr. Rudick, for his statement concerning the taking risk out of a risky enterprise. I will use the form of rhetorical question that requires no answer:

Should Government make it a purpose to take the risk out of risky enterprise, to equalize the risky and the safe?

I happen to be engaged in educating young men going into business. I tell them it is fun to get into risky business because they will be responsible for the problems they encounter.

Mr. MILLS. Let me conclude if I may, with this question:

To what extent does the panel think we could meet the objectives of strengthening built-in flexibility, providing more efficient use of resources, enhancing the competitive position of small and new businesses, if we were to do two things: Broaden the tax base by restoring the eroded areas of the base—we are in the field of corporate tax now, and two, provide a lower normal tax rate and a higher surtax rate with a top combined rate of, say, 50 percent?

Mr. Rudick? Is my question understood?

Mr. RUDICK. It is understood if you mean that for an individual you have a top rate of 50 percent.

Mr. MILLS. We are talking about the corporate tax.

Mr. RUDICK. The graduated rate of corporate tax.

Mr. MILLS. No; provide a lower normal tax rate.

Mr. RUDICK. Instead of the 30 percent we now have to provide a lower one.

Mr. MILLS. Yes; which of necessity would require a higher surtax rate, with an overall effective rate of 50 percent. That is the second suggestion. The first suggestion, that we restore the eroded base.

Mr. RUDICK. On the first one I certainly think that a restoration of the eroded base would be helpful. On the second one——

Mr. MILLS. Helpful in what way?

Would it strengthen built-in flexibility, would it provide more efficient use of resources, would it enhance the competitive position of small and new businesses?

Those are the three things I am thinking about in connection with the two points.

Mr. RUDICK. Well, it is hard to generalize. I think you have to look at it from the viewpoint of a particular company. For some companies certainly it would enhance the competitive position if you took away the advantages enjoyed by other companies, who might be more fortunately situated taxwise. As to the use of resources, I don't know frankly. What was your third?

Mr. MILLS. Would it enhance the position of small and new businesses?

Mr. RUDICK. There I thought it might; yes.

On the other question of whether you should have a lower surtax, a lower normal tax and higher surtax, that to me doesn't make good sense. I would be in favor of abolishing the graduation in the corporate tax altogether.

Mr. MILLS. No tax under $25,000?

Mr. RUDICK. Yes. Under the present system, let's say, a taxpayer conducts 40 different retail stores in different cities, he gets a terrific tax benefit as against another man who conducts a department store in 1 city but who might have as much income as the 40 combined.

What it does is to permit people who can do so to fragmentize to get the benefit of the lower tax rate on the first $25,000 of income. I would go the other way and take away the lower rate applicable to the first $25,000 of income, and whatever tax saving results, I would use to reduce the corporate tax generally.

Mr. MILLS. I probably overlooked an important part by not observing, before I asked the question, that we have been told by other panelists that the present corporate tax structure may not be deterring as much to some of the larger businesses as it is to smaller businesses in the accumulation of capital resources for expansion and growth.

If there is a problem in connection with small and new businesses, I was merely throwing out a possible way of giving some relief to such a problem as may exist in small and new business.

Mr. RUDICK. You mean the smaller corporation isn't able to accumulate as fast relatively speaking as the big one?

Mr. MILLS. That has been the testimony by other panelists heretofore.

Mr. RUDICK. According to my experience, and observation I don't think that is so. I think small businesses if they are properly run, if the right people run them, do expand and the proof is that they are expanding.

Mr. MILLS. In other words, existing tax structure is no greater deterrent to small and new business than it is to full grown business?

Mr. RUDICK. I don't think so. I would approach the problem the other way, by lowering the individual rates so that a man wouldn't have to incorporate if he didn't want to and could go into business and pay lower rates by doing business in partnership form and individual form. I think the present surtax rates are too high. They have probably passed the point of diminishing returns—not because people stop working. I don't believe there is much in that.

Mr. MILLS. You don't believe the corporate rate structure needs to be changed, then, in connection with the desired goals of this subcommittee, of economic growth and stability?

Mr. RUDICK. No; except I would eliminate the graduated corporate tax and make it a flat rate of tax.

Mr. MILLS. Professor Taylor?

Mr. TAYLOR. I don't believe I have a comment, Mr. Chairman.

Mr. MILLS. Professor Keith?

Mr. KEITH. I am not sure I can entirely agree with Mr. Rudick on this point. It seems to me that a 50-percent or even a 30-percent tax is inevitably going to make it difficult for a small or growing concern to finance its expansion particularly when a large part of this has to be done out of retained earnings. On the other hand, the suggestion that you might lower the rate at the bottom for small business, and keep a high rate at the top for large business, always poses the difficult problem of what do you mean by small and large.

I think the concept varies a good deal from industry to industry. What is small in one industry may be medium sized or large in another. You always run into this problem when you try to differen-

tiate between big and little business. Where should you draw the line? If you draw it too low you are not going to do any good to small businesses in some industries, and if you draw it too high then your high rate tax will fall only on a relatively small number of very large corporations. I am inclined to agree that a lower rate on the smaller firms, if you could identify them, would make it easier for them to finance their growth. On the other hand, I would agree with Mr. Rudick that there are some risks in introducing the graduated principle.

Mr. MILLS. Don't misunderstand me, Professor Keith.

I am not at all suggesting the graduated principle. I suggest, just as we toyed with the idea in the Ways and Means Committee initially when we were increasing the corporate rate from 47 to 52 percent, whether we should apply the 5 percentage points to the normal or to the surtax. We put it on the former and raised it to 30 and the surtax was left at 22, so that we could get more money. That was what we were thinking about, and that was the compelling reason for doing it. We would have got less money if we raised the surtax from 22 to 27 and left the normal at 25. I am thinking now about this question of growth, which must to some extent, at least, must come through small and new businesses in the United States.

Now, if we are, in our present tax structure, deterring to any great extent, growth by those businesses, then we should seek a way to eliminate as much of that deterrent as we can in tax policy.

Mr. KEITH. I think this goes back in part to the question of incidence. If it is correct that the small growing firm is not in as good a position to pass the tax on, as the larger firm, then subjecting these firms to a high rate tax, accentuates the difficulty you have in maintaining a steady growth of small enterprises.

There are, of course, a number of angles to this, and it is a little hard to generalize.

Mr. MILLS. Just as a general position, do you believe that tax policy for the future should be less deterring upon small and new businesses than the present tax structure?

Mr. KEITH. I think the present rate is pretty high.

Mr. MILLS. Is it the rate or is the exemption from the surtax too low?

Mr. KEITH. Well, you could lower the effective rate by raising the exemption.

Mr. MILLS. The effective rate is what you are talking about?

Mr. KEITH. The effective rate is pretty high.

Mr. MILLS. Mr. Tarleau?

Mr. TARLEAU. Just very briefly, I think the points have been pretty well covered by what Mr. Rudick and Professor Keith have said. I do feel this: That to some extent I disagree with Mr. Rudick in the effect of the corporate tax rate on the small business as against the large one. Of course, we do have this question of definition, but I feel very keenly that any removal of the 30-percent rate or increase of the 30-percent rate in an attempt to get a lower overall rate, or anything that would increase the burden on the smaller corporations in any sense would be or could be almost disastrous to a great many of the small businesses. I think the increase from 25 to 30 percent, which I can tell from personal experience, with certain small businesses, was a real hardship in the ability to go forward, and I do believe that if

there is to be a revision of tax rates, it is the small businesses, those for whom we have given some kind of consideration against the overall 52 percent tax, that need the first consideration.

Mr. MILLS. I was throwing out the possibility not of increasing the normal rate but of decreasing the normal rate, and increasing the surtax rate, so as to have an effective rate of 50 percent, you see.

Mr. TARLEAU. Well, I believe that may very well have some merit to it. I think that may have some merit to it.

I realize all the time the very excellent technical point that Mr. Rudick brought up, which is inherent in this, splitting up, of course, to take advantage of those lower rates.

Mr. MILLS. The panel is not always interested in my position, but I am reminded of the postion that many of our elder statesmen who dealt with taxes a few years ago said they would like to be able to maintain at that time.

Namely, that taxes on corporations would not be in excess of 50 percent.

They thought that anything in excess of 50 percent was in the direction of great trouble, particularly to small and new businesses, but because of the necessities of the hour, they, along with me and others, had to vote for the 52-percent rate.

Mr. Curtis will inquire.

Mr. CURTIS. I first wanted to point up the remark of Mr. Rudick, made in his paper, which I thought as, at least from my standpoint, very observing.

He said, "Most successful businessmen are businessmen first and tax avoiders second," and I personally think that is so, and I think that our major problem, at least when writing taxes, is to attempt to conform the taxing laws to economic realities so that the businessman can be first and second concerned with business problems rather than being affected by taxes. I think we run into difficulties where, through our laws we are not properly affecting, or not accurately portraying economic situations.

In all of these papers it seems to me our difficulties do arise where we have been unable, in our tax laws, to take proper cognizance of economic realities. That comes to a third comment, that as far as I am concerned, our tax problems stem from economic ignorance. The more I try to get into get some economic facts in order to guide us in doing what we have to do in the tax field, the more I realize how grossly ignorant we are in this field.

With that in mind, I want to pick up the subject that Mr. Mills was discussing earlier, and that is this dividend credit.

First I might say that, as Mr. Mills stated, when that matter came before the Ways and Means Committee our concern was created because we had been told by economic observers, businessmen, and so forth, that the situation of equity capital was not healthy, and that something ought to be done to get a better balance in our corporations.

That arose in my judgment, and the way it was presented, from the differentials that existed in our tax laws—I used the word differential rather than preferential—the differentials existing in our tax laws between different kinds of capital formation which have been mentioned: One is the equity issues, another borrowings of various varieties and finally retained earnings. Original thinking was to

try to modify that differential at the corporate level. Then we got into this problem, as one of the papers said, the undistributed profits tax of 1936 was regarded as a great bugaboo, which admittedly scared the commmittee off of that particular line of thinking. I was very interested in Mr. Rudick's observation that maybe we shouldn't be so scared about doing those things at the corporate level. But at any rate, the dividend credit, as everyone I think realizes, was only part of a long-range plan and it was watered down considerably when the Ways and Means Committee finally passed the thing out. But the economic facts that I want to know—and I think we should be guided on it—are, No. 1, whether or not our premise is correct that the situation of equity capital in our corporate structure was dangerously low, and if it wasn't, then our basic thesis is wrong.

Secondly, did we, or can we, through such maneuver, change the differentials between forms of capital formation so that more money will be channeled into that area.

I am going to go on to state this whole thing because I want some comments on it. One thing of course, we have to think of is the revenue effect. A lot of people talk about we are going to have a revenue loss but we would not have had a revenue loss, or there would not be a revenue loss if we were able to switch $1 billion from borrowings into new equity by giving the stock dividend differential.

I think you can follow my thinking on that quite easily, because the interest on borrowings escape the 52 percent corporate tax, and if it is equity capital that you are borrowing, it pays the 52 percent tax. Furthermore, if we switch it, as the thought was, from retained earnings into new stock issues, we gain half the revenue effect, because the retained earnings are then declared out in dividends, and we then get the individual income-tax return on that. So it all comes back to whether the theory was right or wrong, because if we did switch, or were able, through this device to switch into more new equity and out of borrowings and retained earnings, we would have had an overall gain in revenue, way beyond the stock dividend credit.

Now, I pause at that point to see if there is any comment or any disagreement with that syllogism. I would like to have comments on it.

Mr. KEITH. May I say this. As regards the premise that something needed to be done to encourage equity financing, I would say that it was correct, even though the ratio of new debt to new equity financing hasn't changed very much during the last decade.

I think there is something to be said for corporations going into the market for funds. The plowing back process doesn't help the new enterprise.

It only helps those that can help themselves, so that the idea of giving an assist to equity capital would seem to me to be a sound approach.

Second, can we change the differential?

Well, I think it has been indicated that we can.

Certainly, the dividend-paid credit would do this because it would put dividend payments more on a plane with interest payments than they now are. It is difficult to say how long it would take to change the financial structure of corporations. Obviously, it would be a slow process, since a good deal of debt matures rather slowly and a change in capital structure is something that would take place over a considerable period of time.

As to the third point, revenue effects, I think there would inevitably be some revenue loss if you were to give a dividend-paid credit, even though ultimately you might recover some of this through a change in the method of financing.

I would expect this to be rather slow and, therefore, I would suppose that immediately you would get a revenue loss.

Mr. CURTIS. Of course, the loss would be over all these issues of stock and we would only gain it back in the individual cases where they actually changed investment.

Mr. KEITH. That is right. You would have to contemplate some revenue loss. You can't do this unless you can afford it.

Mr. CURTIS. Mr. Taylor?

Mr. TAYLOR. I have some doubt that this kind of inducement is going to work on both sides of the market—the supply side as well as the demand side for equity securities.

It may work on the demand side. I can see where it might, that it would bring further purchasing of equities—would bring more purchase of equity issues into the market.

On the other hand, when enterprise is enjoying prosperity, as when individuals are enjoying prosperity, they go into debt because they see the advantage, first, of obtaining cheap capital. If I can borrow at 5 and make 6 or 7, it is good business, regardless of the deductibility of the interest on the debt.

Some debt reduction takes place when there is a depression severe enough to make it impossible to meet fixed charges.

It takes place whether or not, either in greater extension of time to pay or by more drastic reorganization, in the turning of bondholders into stockholders and stockholders into sackholders. That can occur when the debt structure is topheavy. I do not like to see any further inducement, expansion, or attempt to sustain prosperity by further extension of credit.

Mr. CURTIS. Thank you. Mr. Rudick?

Mr. RUDICK. I have no comment.

Mr. MILLS. Mr. Silverstein?

Mr. SILVERSTEIN. No comment.

Mr. CURTIS. Then I go on to the next point, which has already been suggested. How would a dividend credit actually create more new stock issues? What will the decision be? Now, Mr. Taylor suggested, as I understood, the way you have suggested it, it might increase the demand side. Am I right in that?

Mr. TAYLOR. Yes.

Mr. CURTIS. My own observation would be that that has never been lacking. In fact, I personally feel that the stock-market-price increase is largely the result of a limited supply of equity issues with a great demand. The demand is there. So if it is going to produce the result, it must come from the other way, and that comes to a very interesting philosophical consideration of what makes a corporation do things. There has been a lot of discussion in the papers on what makes a corporation do things, and that, of course, varies with the kind of corporation, whether it is a public corporation or whether it is very closely held. This comes back to the question of how much influence, I would say, a stockholder's thinking has on what the corporate management does.

That gets back to our investment differentials, because I think this: That with the differential the individual stockholder has a 25-percent capital gain, or zero percent on his capital gain, if he passes it on to his heirs, in relation to his, usually up in the high brackets of 91 percent of 87 percent now. That differential makes him want to see a corporation retain its earnings, because he gains considerably from that. So to that extent he and management—even in publicly held corporations management are stockholders, too—are in accord, certainly management would go with great credit among the stockholders who have that kind of thinking if they finance through retained earnings.

To that extent I would think that the stock-dividend credit would tend to work against that kind of thinking. Likewise, in fact, this same stockholder would be interested, too, in the corporation management borrowing instead of issuing new equity, because of course, then, they work on this capital that they can deduct from the corporate gross income. So, it seems to me that pressures on management have been very great, at least among this investing group, to continue the process—both the process of retained earnings, financing, as well as borrowing financing.

As far as that group is concerned—and from what other papers have indicated, and this gets back to the question of seeking economic facts—that the bulk of stock is held by the higher bracket income people. So it does look like that they are the ones whose thinking we have to get into if we are going to find out what will change this process.

As I have commented on this stock-dividend credit, if the results are achieved, we will take more taxes from the investing group, not less. So I don't think it is a credit to them. It will put less emphasis on these differentials that the investor in the large-income brackets has on that kind of financing.

My labor friends are all arguing that this was for the benefit of the rich, that this economic situation was created for the man with the dollars that he doesn't need for consumption. Where the man with dollars for investment is in better position to compete for the equity stock that is available than the little fellow who always is on margin, whether he can convert something that might be a consuming dollar into an investment dollar; he can't compete for that equity security against other investing persons who have available the full effects of the differentials.

Now, I make that observation to see what further comment there might be from the panel as to where my thinking might be wrong, or any observations on it.

Mr. Tarleau?

Mr. TARLEAU. Well, I am not an economist, and what I said is pretty uninformed, except through actual experience in dealing with corporations and directors' decisions and management decisions as to what type of financing and what type of distribution policy to follow.

There are at least a significant number of quasi-public corporations. By that I mean, corporations where there is concentration of stock ownership in a few hands, but a large number of stockholders owning a significant part of the corporate stock, where there has been a public issue, but there are large stockholders that hold large parts or blocks of stock. This is particularly so in public companies that have gone on the market. I have handled in my time quite a number of those,

and there is always then a competing desire on the part of the stockholders, the larger stockholders, those in the upper brackets, to retain the earnings, as you have indicated, for capital appreciation. You also mentioned the fact that if they are well on in years, there is the stepup in basis for whatever part that plays, and the desire of the public stockholders to get their rents, so to speak, from their investment.

The pressure on management is greater to the extent that the tax benefits to the smaller stockholders are in distribution greater and I think that attacks credit of that kind, at least in my experience, has been one of the things in our stockholders meetings that has encouraged them to ask for greater dividends.

There is always the argument even with the smaller ones, "You can get a capital-gain differential, too, if you hold on."

But that argument means less, it continually means less to the smaller stockholder if he does get a present credit with respect to that distribution.

Mr. Curtis. I am happy for that observation. Of course, that was our theorizing, and frequently theory is entirely different from actuality. You have had experience and know what actually does go on. I am glad to get that view. That is what we figured would create that kind of impression. Whether it has done it in sufficient degree to bring about a switch, we don't know, and maybe as Mr. Keith suggested, it is hard to measure that thing, I agree. But, by George, I think we ought to try to measure it any way we can.

I might make one suggestion. General Motors—and this is what I was told—when they recently issued, I think, 100 million on a new equity issue, had been planning to issue it in bonds, and made their switch. Of course, their thinking was probably fairly well balanced but this thing, this stock-dividend credit thrown into the balance was enough to make them issue new equity series. That is the kind of thing I think we should know about if we are going to judge. If that did happen, that is very significant and if those are the reasons, and if that has been occurring in other areas. To another panel group I made this suggestion: we had the converse happening in some instances where some corporations were drawing in a pro rata of their equity issue and refinancing that drawing in through bank borrowings, or in some instances actually issuing borrowing type security, like a bond. I think that process, to the extent that it is occurring has been reversed and I attribute that to this stock-dividend credit.

Mr. Taylor, do you have any comments on this?

Mr. Taylor. I like very much the way the discussion is going. It makes me regret, however, that the Italians ever invented double-entry bookkeeping. I think they are to blame.

The test of capacity to support Government through taxation is income received from the use of resources, personal, human, and acquired. Whether those resources are acquired by debt, or whether they are married, or whether they are saved is of minor significance, if we emphasize the earning, the income that can be obtained from the use of those resources.

Corporation A is successful if it earns 10 percent after expenses.

Corporation B is less successful if it earns 5 percent.

Taxes laid with primary reference perhaps to what enterprise, corporate or otherwise, can earn upon the resources which it marshals

would be more in accordance with taxpaying capacity than taxes which induce operators to go over to the other side of the balance sheet and manipulate, by shifting from equity to debt, by increasing their equity, by withholding earnings from those who have made the investment, by splitting stock in order to get different distribution, by splitting stock and immediately changing the dividend yield percent, making stockholders wonder why didn't they get that same dividend yield percent before the stock was split, and giving them no answer.

Of course, the question can be raised by some timorous individual, in a meeting of 1 million common-stock holders in a large corporation, but he doesn't get the answer. If the tax could be made with reference to how successful the user of capital is, regardless of how much saving he might make by borrowing cheap capital, giving leverage to ownership capital, or what not, you would be back to one of these economic realities that you well asked for, Mr. Curtis, at the beginning of your questioning.

Mr. CURTIS. Thank you.

That is all I have.

Mr. MILLS. Senator Douglas?

Senator DOUGLAS. Mr. Chairman, I think that, purely accidentally, Senator Goldwater has been low man on the totem pole and has not had his share in the questioning. I know that has been purely accidental, and I would suggest, therefore, that he continue the questioning, and then when he is finished I shall inquire.

Mr. MILLS. Any rule caused by the chairman that results in Senator Goldwater being low man on the totem pole, I can asure you, is unintended.

Senator GOLDWATER. I don't object to that role, because I only have one way to go, and that is up. I wouldn't want to be the top man, because he has only one way to go, and that is down.

Mr. MILLS. Senator Goldwater will take advantage of his opportunity to go up right now.

Senator GOLDWATER. I am sorry that Mr. Leggett could not make it this morning.

I hope he does not have to blame it on American Airlines, because he has one more, TWA, that he can blame it on, too.

I did want to ask him some questions, and I was hoping in his absence we could get some general discussion. Some of the discussion has already taken place. I am going to read from his general paper, on page 609 of the Green Book. He has two specific suggestions to make, and I wanted to discuss the first one first. [Reading:]

> Regardless of what general conclusions are reached at these hearings, there are two matters which I feel should have the immediate attention of the Congress. They are: (1) Tax relief for small businesses, which everyone is in favor of, but which no one does anything about.

He says on page 610 in discussing a suggested now scale for corporate taxing, and I quote:

Turning to the next page, 610, I have to read, because you have to know Mr. Leggett to appreciate the humor that he is putting into economics, thereby making economics a very favored subject in my State.

> The following is a simple and logical way of taxing small businesses. I suppose the chief objection to it will be that it is simple and easily understood.

He suggests this graduated scale of corporate income taxation, 10 percent on the first $25,000 of net income, 20 percent on the second $25,000, 30 percent on the third $25,000, 40 percent on the fourth $25,-000, and 50 percent on all net income above $100,000.

I have not heard a lot of disagreement with the thought that the present corporate scale is working a hardship on small business. I believe I remember Mr. Rudick saying that he did not feel that it did. I would like to have some discussion on not particularly this suggestion of Mr. Leggett's, but reopen the discussion of the harm that I feel is very apparently being done to the small business of this country.

It might be true that at the present moment the corporate tax scale is not working an undue hardship on small businesses, but it did work a hardship on it during the inflation of the postwar period when the tax rate ate up a sufficient amount of the net income to, or the gross income, to prohibit any reinventory, and businesses went out of business.

I want to add one comment before we discuss this, if you want to.

We now have big businesses in this country that we are rightly concerned with, but I believe we are building new big businesses by this unrealistic tax structure.

I say that because we find small businesses being forced to join other small businesses in order to survive, not only these taxes but other taxes that are very complicated.

Now we are not building General Motors or General Electrics, but we can find situations around America where retail businesses dominate a community—one group of retail businesses, one group of drug stores, one group of grocery stores, because they have gathered together as a result of having to survive and having to give in to the American desire to grow, and the only way they can do it, because they are too small to borrow the type of capital they need, is to go in with a neighbor or the competitor and create what I feel is the beginning of a monopoly situation in America that will be far more dangerous than the giants that we can watch today.

Have you comments on that?

Mr. Rudick. Well, Senator, to the extent that the problem exists—and I agree that this does exist, although in my personal experience I have not seen small businesses hampered, but maybe that is because I do not know enough small-business men, whatever that may mean, but if the problem exists—and I agree that it does—I suggest a better way to approach it is to lower the rates on individuals in brackets, let's say from $15,000 to $200,000 and let these small-business men, if they want to, be taxed as if they were individuals or partnerships, even though they are doing business in corporate form.

I think that would be a more effective way, a more equitable way than making lower rates of tax for the first $10,000, $25,000, or whatever you will of corporate income with all the problems that that generates.

Senator Goldwater. Well, now, would there be any decrease or increase in the overall revenues collected from your method compared to the present method today?

Mr. Rudick. I do not know, frankly.

Perhaps there would be some decrease at the beginning, but actually, ultimately as these small businesses grew larger, the ultimate result might be larger revenue rather than smaller.

Senator GOLDWATER. If the corporate rates were decreased in the lower brackets, wouldn't it tend to spread that money further than decreasing the surtax, or the tax on individuals?

Mr. RUDICK. Well, I would doubt it. If you reduced the corporate rates lower, and the lower bracket further you would probably have more fragmentation of business.

An individual, no matter how rich he is, will try if he can to do business under 100 different corporations instead of 1.

Senator GOLDWATER. That is what I am afraid of in your approach, where the approach of reducing the corporate tax in the lower brackets I think would tend more to strengthen small business and get that small business up into the next bracket, and on up into the higher brackets under his own steam and not have to depend on going together with others, or depend entirely, as is I would say most of the cases—I would not want to guess at the percentage—that depend entirely on outside capital.

Mr. RUDICK. You would do that under my approach, too.

Senator GOLDWATER. I appreciate that you could do that.

I have seen this work often in small communities. I have a brother that served on a discount committee of a bank. He has shown me statements, and asked me what I thought of the statements.

I would say "They look pretty good." He would say "We just had to close them out today."

That was back in the days of inflation and they did not have enough to reinventory themselves, neither did they have the borrowing capacity.

I think this is one of the greatest problems that faces the American Government.

Mr. RUDICK. I agree with you.

Senator GOLDWATER. I agree with Mr. Leggett's statement, that everybody is in favor of doing something about it but nobody does it.

We worry ourselves to death about 52 percent taxes on firms making a hundred thousand or more. There are not a lot of those in this country.

We worry ourselves about that poor individual who has to pay 91 percent income tax. I would not mind being up there. I am more concerned with the fellow that has a small corner grocery store, a drugstore, retail business, who is making 5, 10, 15 thousand dollars a year, or $25,000 a year, the men that comprise the great bulk of American business and American initiative, and I hope that out of this thinking will come some definite action by the Congress.

I do not think we will lose income or tax revenues. I think it will in the long run enhance our physical situation, by giving some relief to this little fellow, and mind you, they are the future business of America, the man who has gotten together $5,000 somehow and started a shop.

I think we are in agreement on the approach to that problem.

Have any of you gentlemen any comments on that?

Mr. TARLEAU. I think, Senator, that there is of course a very real problem, and I have seen it personally through family experience, the

difficulties of starting a new business, finding the capital resources to maintain it during its growth period.

I feel one of the things that we must not overlook is that there—well, in the first place, my own belief is that we are never going to be able to equate the power of the little corporation with the power of the big one.

There is the power in concentration, and in bigness, which we are just not going to be able to meet.

There are competitive advantages which are so serious, and sometimes so all-embracing that it is useless to try to continue without merging into some larger group and some more powerful entity.

That is something that I think the tax system can effect only very indirectly by at least not encouraging a trend in that direction, rather than putting an end to it, but I think what should not be overlooked is that there may be a combination of things that should be done for small business without necessarily one overall panacea.

I think that for example the point that has been made, that small businesses—that is, small corporations, should have the privilege of being taxed like partnerships, and not have to pay a corporate tax for the privilege of doing business in corporate form, is one that an attempt was made at—during deliberations on H. R. 8300 and for one reason or another, had to be abandoned.

I think further effort should be made to put that in the law.

My own experience is that in certain instances, the privilege of being able to do business in corporate form and to treat the income and losses as those of the individuals who have started that corporation could be of a great deal of benefit to small business.

Now that in and of itself is not necessarily enough, but the fact that it does not answer all the problems should not deter us from at least doing that much for small business and my concern has merely been that every time one makes a suggestion, other points are brought out which that suggestion does not necessarily answer.

I think that it may need more than one statutory provision in the tax laws to take care of small business.

The rates, I think, obviously are of a great deal of importance but I think the ability of the individual stockholder to take the corporate losses in small business during that period may be of extreme help to small and growing businesses.

Senator GOLDWATER. Have any of you other gentlemen a comment on this question?

Mr. Taylor?

Mr. TAYLOR. As long as we are all looking at page 610, I would like to add that I buy the principle 100 percent, graduated scale of corporate income taxation percentage-wise, with this correction: That the percentages be applied, not on the dollar figures of net income, but on percentages earned on invested capital.

Senator GOLDWATER. You must have a lot of good accountant friends.

Mr. TARLEAU. The very word I suppose makes the lawyers around the table shudder.

Both when I was with the Treasury and when I was out in practice, if there was one term that would give me a nightmare, it was the term "invested capital" but nevertheless, that is without in any way

denying at least the theoretical validity of the point that Professor Taylor makes.

Our experience with a return on invested capital in the excess profits tax law has not been a very happy one.

Mr. TAYLOR. Mr. Chairman, it is widely used in one large field, public utility regulation. The Commission asks, "What have you invested that is necessary in the public service?"

"Total up your assets. You are entitled to a fair return upon those assets." The Commission is on the left hand side of the balance sheet when it asks this basic question.

Senator GOLDWATER. That presents an interesting approach to it. I do not think we have time to argue that out here. There is a lot of argument as to just what capital investment and assets consist of.

It depends a lot upon the type of partnership or corporation, whether it is big, small, closely held or loosely held, or whatever it is.

To end this particular part of the question, I wanted to ask, I want to read from the Joint Economic report, the report of this committee, first session of the 84th Congress, some figures that bear upon what we have been discussing, and I quote from page 35:

> Mere numbers of mergers do not throw light upon the magnitude or significance to competition, but it is significant that preliminary figures released by Federal Trade Commission show an average of 775 mergers per year for the 1951 period the latest period for which information is available compared to 201 per year during the preceding 3-year period and 110 per year during the years preceding World War II.
>
> In the years preceding the stock market crash the number of mergers steadily increased from 300 in 1923 to 530 in 1925, 841 in 1927, and 1,216 in 1929.

I do not suggest for a moment that increasing mergers are any indication of a pending economic doom, but I do think the increasing number of mergers will be found down among the small and middle-sized businesses, instead of up in the economic giants, and it is something for us to be concerned about.

I have one more question.

I will get to this quickly: On page 609 of Mr. Leggett's statement, the second suggestion that he makes, and I read:

> 2. The menace of tax-exempt organizations including cooperatives, mutual associations, educational, and charitable foundations, and pension funds.

He has more to say on that on page 610.

Without agreeing or disagreeing with Mr. Leggett's approach, because I know of his great interest in this, and had he been here he would like to have had this discussed, I want to read from the Congressional Record of February 9, in preface to my general question for him:

> The staff of the Joint Committee on Internal Revenue Taxation estimated that the full taxation of cooperatives, savings and loan associations, mutual savings banks, mutual fire and casualty insurance companies, would raise approximately $800 million in new revenue. Those estimates, however, were made in 1951, and many of these organizations have expanded their operations substantially since that time.
>
> For example, the savings and loan association capital has nearly doubled since that date, rising from $16 billion at the close of 1951 to more than $31 billion today.
>
> It appears, therefore, that the United States Treasury might be losing in excess of $1 billion annually.

Do you gentlemen feel that this is of sufficient importance for this committee to be concerned with it in its recommendations?

Anybody can answer that.

Mr. RUDICK. I do. I think we should be concerned with it.

Incidentally I think Mr. Leggett has an erroneous assumption. He assumes that educational institutions and charitable foundations can now carry on business without paying tax.

That isn't so except for some few. Except for church organizations, these others have to pay taxes when they engage in business competing with other enterprises.

I think the whole question of cooperatives and their exemption from tax should be looked into. I think it is very important.

Senator GOLDWATER. Does anyone else have anything to comment on this?

Mr. Leggett feels that it is very serious. He says on page 610, and I quote:

that it is a colossus which will ultimately destroy our private enterprise economy.

That is quite a strong statement coming from an economist. I thought it might bring forth some comment from his colleagues.

Mr. KEITH. I will comment on that. I think Mr. Leggett is exaggerating the importance of the problem. Take the one area, which is usually emphasized, the farm cooperatives: There is no doubt but that certain types of cooperative organizations, the super co-ops have had an impact on the small independent taxpayer.

Senator GOLDWATER. Knowing Mr. Leggett as I do, I know he is not directing these remarks basically at the farm cooperative. That was set up under the original intent of the law.

He is directing it at the large cooperative that is now in the oil well, the tanker business and in the general business of the coutnry.

Mr. KEITH. That is right.

The only point that I wish to make here is that these super co-ops are a pretty small part of the whole cooperative picture. Only a small fraction of the total number of cooperatives in this country are really engaged in these sorts of operations.

Senator GOLDWATER. Not dollarwise they would not be.

Mr. KEITH. It depends on how you measure it.

Senator GOLDWATER. I am measuring it from taxable——

Mr. KEITH. I can't recall the figures, but I think a report was prepared by the Treasury some years back in which an attempt was made to differentiate between the various types of cooperatives and to estimate how much business they accounted for. Without denying that there is a problem here, I still don't believe that the cooperative movement is a colossus that will bring down the price economy. At one time there were rumors of Sears, Roebuck becoming a cooperative, but nothing came of that.

Senator GOLDWATER. Even if they could have, would they?

That brings us back to this, nobody knows anything about business and that is the human equation. When they desire to make a dollar American businessmen will do most anything inside the law and some of them step outside of it. What did Mr. Galbraith call it? He had a pretty good term for it—something about lunacy. I don't think a man is crazy who wants to make a dollar. Mr. Galbraith calls it seminal lunacy.

I don't want to press this point, because it is quite obvious that without Mr. Leggett here to express his own opinions, I would only

be assuming what he would have to say, and if you don't have any more comments on this, I am happy to have had the occasion to get it into the record, because while it might not be the colossus that he pictures it, I as a businessman can see it becoming one, unless we correct the tax laws and make business a little—make the relationship between business a little more equitable. If the cooperative is not a farm cooperative, in an isolated community, serving a group of farmers, but if the cooperative is set up to sell gasoline, to deal in oil, to deal in transportation, to deal in buildings, to deal in retail and wholesale businesses, that come in direct competition with the free enterprise system and do not pay the same taxes, I have a feeling that it can become very dangerous.

Mr. KEITH. You may be right. I would like to point out that this has been possible largely because these cooperatives have been able to retain tax free a substantial amount of the receipts taken from their enterprises. I believe the cooperative problem could be solved by differentiating between those receipts which are actually kept in the enterprise and those which are paid back to the patrons. If you exempt payments to the patrons and tax what is kept, you will be going about as far as you can in achieving tax equality in this area.

Senator GOLDWATER. If you have much. Now the low man on the totem pole will yield to the top man on the totem pole.

Senator DOUGLAS. If——

Senator GOLDWATER. Before Senator Douglas is recognized, do you not think it would be appropriate for us to reserve the right for Mr. Leggett to include in this record his summary statement if he desires to do so? I think he should, by all means. He might even get it here this afternoon.

Mr. MILLS. He might get here this afternoon. If he doesn't, we will grant permission for it to appear in this record this morning, if he doesnt' appear this afternoon.

(Mr. Herbert A. Leggett's statement follows:)

CORPORATE INCOME TAXATION

EFFECT OF THE CORPORATE INCOME TAX ON CORPORATE FINANCING

Herbert A. Leggett, Valley National Bank, Phoenix, Ariz.

Let me confess at the outset that, with the limited information available on this subject, I have been unable to appraise or measure the effect of the corporate income tax on corporate financing. I doubt that this can be done without extensive research encompassing many different industries and representative case histories throughout the country.

Many of us are familiar with individual instances from which certain conclusions can be drawn, but the aggregate or composite effect is something else again. Therefore, I shall confine myself largely to entering in the record some background material. Then I shall comment on certain phases of the problem which I believe are not subject to any great argument.

First, let us look at the volume of corporate financing over the past 20 years as divided among bonds, preferred stocks, and common stocks. We find that the total, excluding issues of investment trusts, trading and holding companies, amounted to about $100 billion, of which bonds represented $80 billion (or 80 percent) and common stocks just over $10 billion (or 10.6 percent). This is a startling comparison and indicates that there is certainly something wrong with the picture. In the relatively favorable postwar II period, for example, our corporations have sold an average of only about $1 billion worth annually in common stocks.

Corporate securities issued for cash

[In millions of dollars]

	Bonds	Preferred stocks	Common stocks		Bonds	Preferred stocks	Common stocks
1935	$2,225	$86	$22	1946	$4,882	$1,127	$891
1936	4,029	271	272	1947	5,036	762	779
1937	1,619	406	285	1948	5,973	492	614
1938	2,044	86	25	1949	4,891	425	736
1939	1,980	98	87	1950	4,920	631	811
1940	2,386	183	108	1951	5,690	838	1,212
1941	2,390	167	110	1952	7,601	564	1,369
1942	916	112	34	1953	7,083	488	1,326
1943	990	124	56	1954	7,534	816	1,213
1944	2,669	369	163				
1945	4,855	758	397	20-year total	79,713	8,803	10,510

Source: Securities and Exchange Commission.

Percentage distribution of corporate securities issued for cash

	Bonds	Preferred stocks	Common stocks		Bonds	Preferred stocks	Common stocks
1935	95.4	3.7	0.9	1946	70.8	16.3	12.9
1936	88.1	5.9	6.0	1947	76.6	11.6	11.8
1937	70.1	17.6	12.3	1948	84.4	6.9	8.7
1938	94.8	4.0	1.2	1949	80.8	7.0	12.2
1939	91.5	4.5	4.0	1950	77.3	9.9	12.8
1940	89.1	6.9	4.0	1951	73.5	10.8	15.7
1941	89.6	6.3	4.1	1952	79.7	5.9	14.4
1942	86.3	10.5	3.2	1953	79.6	5.5	14.9
1943	84.6	10.6	4.8	1954	78.8	8.5	12.7
1944	83.4	11.5	5.1				
1945	80.8	12.6	6.6	20-year total	80.5	8.9	10.6

If we go back to the period of the 1920's, when the corporate income tax ranged between 10 and 13½ percent, we find that the record is not too different. In the 11 years from 1920 to 1930, inclusive, corporate security issues totaled $52 billion, of which about $36 billion consisted of bond issues.

It is true that bond issues represented only 67.7 percent of the total but there were other factors at work including much higher interest rates. Actually in only 1 year (namely, 1929) did bond issues represent less than 50 percent of corporate securities offered for cash.

The safest conclusion to be drawn is that taxation is only one of several factors affecting corporate financing. Other factors, such as depressions, wars, and money rates, may be equally or even more important much of the time. In other words, the relatively small difference in financing methods during recent years in comparison with the period of the 1920's may be more attributable to low interest rates than to anything else.

The so-called excess profits tax, which imposed a ceiling on net earnings, was, of course, a definitely determinable factor during the periods when it was in operation. This undoubtedly was responsible, in large part, for the anemic condition of common stock financing during the war but, in all fairness, it cannot be regarded as pertinent to this discussion.

Corporate securities issued for cash

In millions of dollars]

	Bond issues	Preferred and common stocks	Percent of total in bonds	Percent of total in stocks
1920	$1,895	$1,071	63.9	36.1
1921	2,112	279	88.3	11.7
1922	2,449	624	79.7	20.3
1923	2,497	736	77.2	22.8
1924	2,973	866	77.4	22.6
1925	3,424	1,299	72.5	27.5
1926	3,967	1,262	75.9	24.1
1927	5,460	1,684	76.4	23.6
1928	4,090	2,937	58.2	41.8
1929	2,987	4,825	38.2	61.8
1930	3,785	1,455	72.2	27.8
Total	35,639	17,038	67.7	32.3

Source: Commercial and Financial Chronical.

There are two other elements in the equation which are of vast importance and deserving of mention, although not perhaps scheduled for exploration at this time. I refer, of course, to the two principal forms of internal financing which do not involve a contribution of new money. These are—

(*a*) Retained earnings.

(*b*) Depreciation reserves.

The retained earnings of corporations in recent years have ranged from a high of $13 billion in 1948 to a low of $7 billion in 1954. Depreciation charges alone totaled more than $13 billion in 1954. Obviously, such huge cash accumulations as these influence importantly the matter of corporate financing.

Another factor of growing importance is the issuance of term loans by banks and insurance companies to business enterprises. Made for periods which may run as long as 5 or 10 years, such loans often obviate the necessity for actual securities issues, either bonds or stocks. They also, as a general rule, provide more flexibility and less redtape than security flotations.

Retained earnings and depreciation charges of corporations

[In millions of dollars]

	Retained earnings	Depreciation charges		Retained earnings	Depreciation charges
1945	$3,600	$6,100	1950	$12,900	$8,100
1946	7,700	4,400	1951	9,600	9,400
1947	11,700	5,500	1952	7,100	10,700
1948	13,000	6,500	1953	7,700	12,000
1949	8,300	7,400	1954	7,000	13,400

Source: U. S. Department of Commerce.

TWO SPECIFIC SUGGESTIONS

Regardless of what general conclusions are reached at these hearings, there are two matters which I feel should have the immediate attention of the Congress. They are:

1. Tax relief for small businesses, which everyone is in favor of but which no one does anything about.
2. The menace of tax-exempt organizations, including cooperatives, mutual associations, educational and charitable foundations, and pension funds.

From time immemorial it has been quite generally agreed that small-business organizations, especially struggling new ones, should be given a type of tax treatment that would permit them to get some fat on their bones so that the first ill wind that comes along does not blow them away. This is relatively noncontroversial. Both political parties are in favor of it, labor is in favor of it, and, needless to say, business is in favor of it. The mortality rate of small businesses is fantastic and tragic.

It would seem to me a fairly simple matter to provide a graduated scale of taxation for small businesses that would accomplish the desired purpose without much loss in revenue. There would probably be no loss of revenue if we take into account the greater stability of employment and business activity that would result.

The following is a simple and logical way of taxing small businesses. I suppose the chief objection to it will be that it is simple and easily understood.

Graduated scale of corporate income taxation:

10 percent on first $25,000 of net income.
20 percent on second $25,000 of net income.
30 percent on third $25,000 of net income.
40 percent on fourth $25,000 of net income.
50 percent on all net income above $100,000.

I have used a tax rate of 50 percent on net income above $100,000 just as a round figure and perhaps on the subconscious theory that the least Congress can do is to reduce the corporate tax rate from 52 percent to 50 percent. This would be easier to calculate and would have the psychological advantage of putting us a 50–50 basis with the Government as far as earnings are concerned.

Regarding tax-exempt organizations, this is a colossus which will ultimately destroy our private enterprise economy. It is something that must be faced immediately while there is yet time to do so politically. When corporate tax rates were low, efficient businesses could offset the disadvantage but, with a tax rate of 50 percent or above, even inefficient and incompetent organizations can operate to the detriment of fully taxed organizations.

There is no justification whatsoever for tax favoritism of the kind that now exists. Pension funds, as well as educational and charitable foundations, are favored enough as it is when the money is funneled into them in the first place. They do not need any further advantage or incentive. They are already getting too big for the good of the general economy.

We must stop looking at this situation as a sacred cow. Even educational and charitable foundations have no right to operate tax free when they engage in business competition with enterprises that are taxed. I see no point in mincing words about it. It is becoming a scandalous racket.

Personally, I believe that, so long as we have an income tax, all income should be taxed.

Senator DOUGLAS. I have only one question that I want to raise, and that deals with the general question as to whether there has been a decrease in the ratio of stock issue to total of stock and bond issues. I would like to refer to Mr. Taylor's statement on page 653 of the compendium, in which treating the third subject he says:

> Competent observers are unanimous in agreeing that the corporate income tax as levied has been responsible for the increase in corporate debt.

Now, it may well be that this is the opinion which is commonly held, but I had occasion to go into this last year, and I found no statistical or historical evidence to indicate that there had been any significant shift in the ratio of stock issues to bond issues.

We had a discussion on this point with Secretary Humphrey when we were holding the stock-market hearings and he produced a table which seemed to indicate that there had been a great decline in stock issues as compared to bond issues in the past World War II period compared with that of the 1920's. When his figures were analyzed, however, it was seen that he had included refundings, and that if one excluded refundings, there was a somewhat different story, because the refundings were mostly bonds, and hence increased the apparent issuance of bonds in the post-World War II period.

We worked for 2 or 3 months to reconcile our figures, and finally I submitted a set of figures to the Committee on Banking and Currency, and he submitted a revised set of figures. His revised set raised the percentage of stock issues from 1945, as compared to those he used

originally, but even so, in my judgment these figures overstated the situation because prior to 1933, his series include investment trusts and trading and holding company issues. Obviously one should not include them but should include only the issues of the underlying companies themselves.

I was able to get the SEC to take figures for those issues out, and I presented the new table to the committee. The correct series, or at least as nearly correct as we can get it, appears on page 629 of the stock market hearings.

This is based on SEC figures, I might say, with the refundings excluded, and with issues of investment trusts and trading in holding companies excluded.

This series of mine was adopted by the committee, and included in its report. I will pass it down to the panel members.

In brief, what it showed was this: If one took the period from 1921 to 1927, inclusive, and excluding the bull market years of 1928–29, the proportion of stock issues to total stock and bond issues, was 23.6 percent, and if one took the years 1946 to 1953 on a comparable basis, the average of the stock issues to total bonds and stocks was 22.1 percent, so that there was virtually no difference.

Now, if one did include the bull market years of 1928 and 1929 that raised the average to approximately 27 percent, but there is some question as to whether we want to encourage the type of corporate financing that was going on in 1928 and 1929. The conclusion which I drew from this, and which until it can be refuted properly, I hold to, is that there is no statistical evidence to indicate that there has been a decline in the issuance of stocks compared to total issuance of stocks and bonds in recent years, despite the fact that in the twenties, of course, the rate of corporate taxation was quite a lot lower—I believe 12½ percent, and during this later period, betwen 47 and 52 percent.

Now, I think these facts are as nearly correct as we can get them, and unless there is something wrong with them, I suggest competent observers should not be quite as unanimous in conclusions to which they come, and I would ask, Mr. Chairman, that the revised tables of Secretary Humphrey, which were withdrawn from his original tables and the tables which I submitted, namely, on pages 627, 628, and 629 of the stock-market hearings, be included at the end of the proceedings this morning.

Mr. MILLS. Without objection, they will be included.

(Information referred to is as follows:)

DATA ON THE RELATIVE VOLUME OF CORPORATE STOCK FINANCING

The figures used by Senator Douglas and Secretary Humphrey on the ratio of stocks to total corporate financing are close together for the 1920–28 period as a whole, although there are differences in specific years. Both sets of figures are based on tabulations made by the Commercial and Financial Chronicle, although the Secretary's figures include refunding issues and investment company issues in addition to issues for new capital. The 1920–28 average of 28.0 percent of new corporate security issues in the form of stock (literally averaging the yearly percentages the same way Senator Douglas did) is only slightly different from the Senator's ratio of 28.31 percent. It appears, therefore, that the inclusion or exclusion of investment companies and refunding issues in this period as a whole makes little difference in the ratio of stock issues to total financing.

The fundamental difference between the two sets of figures is in the postwar period. For this period the Secretary relied completely on Securities and Exchange Commission data since, as the Senator indicated, this provides the most

dependable source available. These figures indicate that 22.0 percent of gross new corporate financing in the 1946–53 period was done through stock issues as compared with the 28.0 percent ratio during the 1920's.

The figures Senator Douglas used for 1946–53 are from two different sources which are not directly comparable with each other. His data for 1946 and 1947 like his 1920–28 figures, came from the Commercial and Financial Chronicle rather than from the Securities and Exchange Commission. But his figures from 1948 through 1953 are part of a different statistical series, prepared by Securities and Exchange Commission and used by the Department of Commerce in developing an excellent body of background data on sources and uses of corporate funds. However, those figures reflect net changes in corporate securities outstanding, not total new corporate issues. Comparable data on the net basis are not available for the years prior to 1933.

The Department of Commerce has prepared a table bringing up through 1953 the series on new capital issues which Senator Douglas used through 1947. That series indicates that 24.5 percent of corporate issues were in the form of stock during the 1946–53 period. The attached tables show (1) the figures on total corporate issues used by Secretary Humphrey, and (2) the figures on new capital issues as brought up through 1953 by the Department of Commerce.

Both sets of figures, therefore, indicate a larger proportion of stock financing in the 1920's than in the 1946–53 period (28.0 percent versus 22.0 percent on the Secretary's figures; 28.3 percent versus 24.5 percent on the Senator's figures as brought up to date by the Department of Commerce).

TABLE 1.—*New domestic corporate security issues, 1920–54*

[Dollars in millions]

Calendar year	Total	Stocks	Percent in stocks	Calendar year	Total	Stocks	Percent in stocks
1920	$2,788	$1,038	37	1938	$2,155	$111	5
1921	2,270	275	12	1939	2,164	184	9
1922	2,949	621	21	1940	2,677	291	11
1923	3,165	736	23	1941	2,667	277	10
1924	3,521	865	25	1942	1,062	146	14
1925	4,223	1,247	30	1943	1,170	180	15
1926	4,574	1,220	27	1944	3,202	533	17
1927	6,507	1,738	27	1945	6,011	1,156	19
1928	6,930	3,491	50	1946	6,900	2,018	29
1929	9,376	6,757	72	1947	6,577	1,541	23
1930	4,957	1,526	31	1948	7,078	1,105	16
1931	2,372	343	14	1949	6,052	1,161	19
1932	644	23	4	1950	6,361	1,441	23
1933	380	152	40	1951	7,741	2,050	26
1934	397	26	7	1952	9,534	1,933	20
1935	2,332	107	5	1953	8,898	1,815	20
1936	4,572	543	12	1954	9,563	2,018	21
1937	2,310	691	30				

Source: 1920–33: Commercial and Financial Chronicle compilation, as reported in Federal Reserve Board's Banking and Monetary Statistics (p. 487); 1934–54: Securities and Exchange Commission, as reported in Federal Reserve Board bulletins and Securities and Exchange Commission annual reports.

TABLE 2.—*New corporate security issues for new capital,*[1] *1920–29 and 1946–53*

[Dollars in millions]

Year	Total	Percent stocks to total	Year	Total	Percent stocks to total
1920	$2,710	38.2	1946	$3,546	41.5
1921	1,822	14.7	1947	4,828	25.3
1922	2,336	24.6	1948	6,254	14.6
1923	2,702	24.4	1949	5,153	18.9
1924	3,322	25.0	1950	4,418	27.3
1925	4,086	29.4	1951	6,300	25.7
1926	4,286	26.3	1952	7,789	22.4
1927	5,216	27.2	1953	7,609	20.3
1928	5,293	45.0			
1929	6,417	62.1			

[1] Excluding refunding issues for all years, and investment and holding company issues after 1924.

Source: Commercial and Financial Chronicle (1920–29 data as shown in the March 1948 Survey of Current Business).

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STATEMENT BY SENATOR DOUGLAS

In view of the discussion which the Secretary and I had over the question of equity financing in the postwar years, I have sought additional information which would shed light on the facts. The original series which I used was from the Survey of Current Business for March 1948 and April 1954 and appeared as a single table in the preliminary staff materials prepared for the information of members of the Banking and Currency Committee at the stock-market hearings. The Secretary is correct in saying that the data for the years after 1947 were based on a series not wholly consistent with that of the previous years.

The Secretary has also gone into the matter at my request and has gathered further information. His information and new tables appear in his supplementary statement. The sources of his table 1 are the Commercial and Financial Chronicle for the years 1920–33, and for 1934–54 the Securities and Exchange Commission who have brought the series up to date on a consistent basis. There is, however, a minor inconsistency in that data as they include the security issues of investment and holding companies through 1933 and exclude them for the years following. His table 2 also has as its source the Commercial and Financial Chronicle.

In view of these differences I have obtained from the SEC a consistent series of corporate security offerings for cash from 1920 to 1954 which excludes investment trust, trading, and holding company issues for the entire period.

The series indicates that on an average of the years basis new stock issues as a percent of total new capital issues were 25.6 percent in 1920–28 compared with 22.1 percent in 1946–53. As the Survey of Current Business for April 1954 points out on page 15, "In the 'bull' market of the twenties, total stock sales were much higher on a gross basis, but a substantial portion of such sales involved changes in existing forms of equity securities rather than raising of new net funds." If, therefore, we exclude 1928 and 1929, the years of the "bull" market, the average of the years was 23.6 percent in 1920–27 compared with 22.1 percent in 1946–53, a difference of 1.5 percent. On the basis of total new stock issues as a percent of total new capital issues for the periods as a whole, the figures are 24 percent for 1920–27 and 22.1 percent or 1946–53, or a difference of 1.9 percent.

Whatever figures one uses, and it is important that we have a published series of figures which can be accepted by all for their relative accuracy, I believe my main point was well taken. That point was the special treatment of dividends under our tax laws was not justified by the argument that existing tax treatment made corporations reluctant to issue new equities. There was no so-called double taxation in the 1920's. Corporation taxes as a whole were far less than in the postwar period. Yet, in the postwar period new equity issues in actual numbers were greater than in almost all years of the 1920's (except 1928 and 1929) and on a percentage basis were only slightly lower.

It is my hope that the SEC table which I have submitted will be helpful in comparing the two periods and in making judgments of policy.

Corporate security offerings for cash, excluding issues of investment trust, trading, and holding companies

Year	Total bonds and stocks	Stock issues	Percent stock issues to total	Year	Total bonds and stocks	Stock issues	Percent stock issues to total
	Millions	*Millions*			*Millions*	*Millions*	
1920	$2,966	$1,071	36.1	1938	$2,155	$111	5.2
1921	2,391	279	11.7	1939	2,164	184	8.5
1922	3,073	624	20.3	1940	2,677	291	10.9
1923	3,233	736	22.8	1941	2,667	277	10.4
1924	3,839	866	22.6	1942	1,062	146	13.7
1925	4,723	1,299	27.5	1943	1,170	180	15.4
1926	5,229	1,262	24.1	1944	3,202	533	16.6
1927	7,144	1,684	23.6	1945	6,011	1,156	19.2
1928	7,027	2,937	41.8	1946	6,900	2,018	29.2
1929	7,812	4,825	61.8	1947	6,577	1,541	23.4
1930	5,240	1,455	27.8	1948	7,078	1,105	15.6
1931	2,584	339	13.1	1949	6,052	1,161	19.2
1932	643	23	3.6	1950	6,361	1,441	22.7
1933	381	152	39.9	1951	7,741	2,051	26.5
1934	397	26	6.5	1952	9,534	1,933	20.3
1935	2,332	107	4.6	1953	8,898	1,815	20.4
1936	4,572	543	11.9	1954	9,563	2,018	21.1
1937	2,310	691	29.9				

NOTE.—Total new stock issues as a percent of total new capital issues: 1920–27, 24; 1920–28, 27.1; 1920–29, 32.8; 1946–53, 22.1; 1946–54, 22.

Total new stock issues as a percent of total new capital issues on average of the years basis: 1920–27, 23.6; 1920–28, 25.6; 1920–29, 29.23; 1946–53, 22.1; 1946–54, 22.

Source: 1921–23, Commercial and Financial Chronicle. 1934–54, Securities and Exchange Commission. 1934–54, same series as used by Treasury.

Mr. TAYLOR. Mr. Chairman, I wonder if I might ask the privilege of taking one other approach and submitting figures as an addendum to the proceedings?

Mr. MILLS. We would be glad to have you do that, Professor Taylor. Without objection you may include them.

(The following was later received for the record:)

STATEMENT OF W. BAYARD TAYLOR, CLAREMONT MEN'S COLLEGE

The figures to which Senator Douglas calls attention consist of national totals. Large corporations weigh heavily in these totals. Significant differences also exist from industry to industry and company to company. Older companies and more successful companies are better able to finance themselves from retained earnings. Capital structures of manufacturing corporations in 1950 show 89 percent equity, 11 percent long-term debt; service trades 71 and 29 percent; tobacco products, 69 and 31 percent; autos and trucks, 97 and 3 percent.[1] Some companies do no trading on the equity. Du Pont has no funded debt, nor does American Smelting & Refining, Armstrong Cork, Boeing Airplane, Borg-Warner, Butler Bros., Cannon Mills, Cluett, Peabody & Co., Coca-Cola Co., Curtis Publishing, Curtiss-Wright—to sample only the beginning of the alphabet.

Even the revised figures in table 2, page 628, of the stock-market hearings do not impair the validity of the inference on page 653 of the tax-policy hearings nor detract from the significance of the data on pages 607 and 654 despite the inclusion of issues offered for refunding purposes. Refunding is as ill advised as new debt, if it is ill inspired. The time to reduce debt is during prosperity. To borrow from Peter to pay Paul simply because current interest rates are low or because debt capital is tax free is to stay in debt for two bad seasons. Furthermore, if the equity-debt ratio since World War II is the same (whether from refunding or new debt) as it was in 1920–28, it is too high for long-run economic stability.

The depression of the 1930's was prolonged because the bond market was depressed, refunding was difficult and costly, and the debt burden excessive. The next dip in the business cycle (and there will be one) will hit refunders hard,

[1] Statistics of Income for 1950, pt. 2, table 4.

will reduce per share earnings for companies trading on the equity. When stocks are widely held, as they now are, by mutual funds, pension funds, and small stockholders, dividend reductions will be even more harmful.

Before we can safely discount the effect of deductible interest on corporate policy any totals, whether of new issues (with or without the inclusion of refunding issues) or of equity to debt relationships, we should know (a) just what companies engage in refunding, (b) why they refunded rather than redeemed their indebtedness, (c) for what purposes the refunders used retained earnings, if any, and (d) whether their retained earnings were sufficient to have permitted redemption rather than refunding.

Errata.—Compendium, page 655, line 3 from bottom: Should be $21,000, not $8,875 and $1,680, not $700.

Senator DOUGLAS. That is all.

Does anyone want to make a comment on this?

Mr. TAYLOR. May I ask one question, Senator? Back in the late thirties, I remember when the SEC was asking for revamping of the corporate structures, or seeking to assist in revamping of the corporate structures of these different utilities and holding companies. They did feel that the difference in treatment between indebtedness and stock was always hindering them in arriving at what they considered a better corporate balance between indebtedness and stock, and I wondered whether you didn't feel that there was that hindrance?

Senator DOUGLAS. The deduction in the case that Mr. Taylor has made seems to be very good and it is also true that in the thirties the percentage of stock issues to total issues—and they were, of course, not so great—was very low except in 1933. For instance, in 1934, the stock issues were only 6½ percent of the total; 1935, 4.6 percent of the total; 1936, 1.9 of the total; 1937, they were 29.9, but fell to 5.2 percent in 1938; 8.5 percent in 1939; 10.9 percent in 1940. It is true that that is in general what was happening during the thirties, and I would agree there seems to be a strong deductive case for what has been advanced. All I am saying is that in the post-World War II period, there is no evidence to indicate that the percentage of stock issues to total security issues was really any lower than it was during the twenties, which have been regarded as the boom period, despite the fact that the rates of corporate taxation differed widely as between these two decades.

That is all I am saying.

Mr. RUDICK. Senator, might I suggest this table would be even more meaningful if you added a column showing retained earnings?

Senator DOUGLAS. Yes, if one takes retained earnings then equities furnished about three-quarters of the capital, and that is a point that was touched on earlier. But I was simply dealing with a very restricted issue, namely the question as to the degree capital was secured by securities and how much by stocks and how much by bonds.

Mr. RUDICK. Perhaps also a showing of the relative price level of the debt versus equity securities during the years too might be pertinent.

Senator DOUGLAS. Yes, I believe that is true but I was dealing with a very restricted question.

Mr. KEITH. I would like to make one additional point there. There was a real problem during the war years when the prospective loss of the interest deduction made a good many corporations in the process of reorganization very reluctant to reduce their debt and convert it into preferred or common stock.

Senator DOUGLAS. That may well be true. All I am saying is if one takes the postwar period, which has been one of rapid expansion on the whole, and contrasts it with the previous period of rapid expansion after the twenties, one does not get the significant difference that one might expect on other grounds. I ask competent observers to observe competently.

Mr. TAYLOR. To have another look?

Mr. MILLS. That is all, Senator Douglas?

Senator DOUGLAS. That is all, Mr. Chairman.

Mr. MILLS. On behalf of the subcommittee, permit me to thank each of you for your appearance this morning. The information you have given the subcommittee both in compendium and in your summary statements today have been very helpful to the subcommittee. Thank you very much.

If there is no objection on the part of the subcommitte, we will adjourn until 2:30 this afternoon, and the clerk will so notify the panelists for this afternoon.

(Whereupon, at 12:45 p. m., the subcommittee adjourned, to reconvene at 2:30 p. m. on the same day.)

AFTERNOON SESSION

(The subcommittee met at 2:30 p. m., Hon. Wilbur D. Mills (chairman of the subcommittee) presiding. Present: Senators Paul H. Douglas and Barry Goldwater, and Representative Thomas B. Curtis. Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.)

Mr. MILLS. The subcommittee will come to order, please.

This afternoon's session of the Subcommittee on Tax Policy will be devoted to discussion of taxation of small business.

As was announced this morning our procedure is to hear from the panelists in the order in which their papers appear in the compendium. At the start of each of these sessions panelists will be given 5 minutes in which to summarize their papers. We will hear from each panelist without interruption. The 5-minute rule will be adhered to. Upon completion of the opening statements the subcommittee will question the panelists for the balance of the session. I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on papers filed by other members of the panel as well as answer subcommittee questions.

Our first panelist this afternoon is Prof. M. A. Adelman of Massachusetts Institute of Technology.

Professor Adelman, you are recognized.

Mr. ADELMAN. These remarks summarize and somewhat extend the written statement previously submitted.

1. The trend in industrial concentration since the 1920's, and even since the beginning of the country, has been mildly downward. Whether this trend has continued since the early postwar is not yet known.

2. The size distribution of business enterprise has in recent years been subject to two forces pushing in opposite directions. One has been a high and stable level of employment, working in the direction of lesser concentration.

A very high level of individual- and corporate-income taxation has worked in the direction of greater concentration. The importance of these and other factors is not known, nor has their influence been traced by studies of particular industries or size groups.

3. Whatever the current trend, it is certainly a very slow and gradual one. Over the short run no substantial changes in concentration are to be expected.

Over the long run, even slow trends may cumulate to large results, particularly since the two important determinants—high employment and high taxes—are expected to persist indefinitely.

4. The corporate-income tax has an effect on the size structure of business because it is apparently not shifted to any substantial degree. Corporate profits before taxes, as percent of income originating in corporate business, were 21.8 percent in 1929, and 21.4 percent in 1952–54.

If we add interest to profits, the respective percentages were 25.4 and 21.9.

These are very broad averages, which doubtless conceal as much as they reveal. An industry-by-industry breakdown, which we do not have, would tell us much more.

Mr. MILLS. Our next panelist is Mr. Edwin S. Cohen, of Hatch, Root, Barrett, Cohen & Knapp, New York City.

Mr. COHEN. Mr. Chairman, in my paper submitted to the committee, I have urged that most serious attention be given to the effect of taxes upon the raising of venture capital for small and new business. If we are to encourage the flow of capital into these businesses to satisfy their financial needs, it is essential to consider the tax position of those who would supply this capital. Unfortunately, their position today is marked by a startling degree of confusion and uncertainty.

Suppose Jones has started a business with $5,000 from his own funds, and the business needs $100,000 for its development. Smith is willing to put up the $100,000 by investing $5,000 for half the common stock and the balance of $95,000 for senior securities, that is, bonds, notes, or preferred stock, to be paid back before anything is paid on the common stock. Under these circumstances, Smith is likely to ask: "Can the corporation be so capitalized that I may own part of the common stock and yet, if the venture proves successful, have a substantial part of my investment repaid to me without prohibitive surtaxes?"

Then, looking on the pessimistic side, his second question is likely to be:

"If the venture fails and my investment becomes worthless, to what extent can I take a deduction on my tax return?"

The answers to these qeustions will frequently have a significant bearing upon his decision whether or not to make the investment.

One would expect that these questions could be readily answered. But, unfortunately, this is not so. If Smith pays in $5,000 for his share of the common stock and supplies the balance of $95,000 against notes of the corporation, there is a serious question today as to whether the amount paid in for notes is not so great in relation to the amount paid in for stock that the notes will be regarded for tax purposes as though they were stock. In that event amounts received in repayment of the notes may be taxed to Smith as though he had received a taxable dividend on his common-stock holdings. This vexatious problem as

to the debt to stock ratio—frequently referred to as "thin incorporation"—plagues those called upon to determine the capital structure of small and new businesses, for no one can determine with certaintly where the line can be drawn.

Again, if part of the $95,000 of senior funds are supplied by Smith for preferred stock instead of notes, one cannot advise him with certainty whether, if the company is successful, the retirement of the preferred stock will result in a dividend to him. The 1954 code established rules which might be followed if common stock is retired, but it left untouched the case in which preferred stock alone is redeemed from a person who also owns some common stock.

Finally, if the venture is unsuccessful and Smith loses his money, there is doubt as to whether the worthless corporate notes constitute an ordinary deduction or a capital loss.

Under the present code a worthless note will represent an ordinary deduction if it is a "business bad debt," but only a capital loss if it is classed as a "nonbusiness bad debt." To obtain "business bad debt" treatment it appears likely from a number of court decisions that Smith must show he is in the business of financing various corporations. In many cases it is a matter of substantial doubt whether the investor is such a frequent lender that he can take an ordinary deduction rather than be limited to a capital loss.

It is of the utmost importance, I believe, to eliminate the doubts and ambiguities which now exist in this field. Subject to revenue considerations, I would urge that serious study be given to the following:

1. Elimination of the "thin corporation" problem by making the debt-to-stock ratio of no significance if the debt would otherwise have the essential earmarks of true indebtedness.
2. Permitting preferred stock to be redeemed without treatment as a dividend if it is held in proportions substantially different from the common stock.
3. Permitting losses on loans to small and new businesses to be regarded as ordinary deductions whether or not the lender can show he is engaged in the business of making such loans.

These changes, I respectfully suggest, would greatly stimulate the flow of venture capital into this vital segment of American business enterprise.

Mr. MILLS. Our next panelist is Mr. James K. Hall, professor of economics, University of Washington. Professor Hall.

Mr. HALL. Corporations, apart from common legal characteristics, display wide variance as to financial size, numbers of stockholders and the extent to which identity exists between corporate ownership and control. From the point of view of stockholder control, corporations may be usefully classified into two groups—the public corporation in which there is effective separation of ownership and control, and the private corporation in which is found close or complete identity of ownership and control.

Private corporations are essentially proprietorships or partnerships dressed in corporate garments. They serve as instruments which fulfill the personal, as well as the business interests of the controlling shareholder or shareholders.

Important tax problems arise when the personal interests of shareholders, influenced by income-tax considerations, find expression in shaping the business conduct of the corporation.

This may, and does, give rise to personal tax avoidance as found in corporate hoarding. Hoarded corporate earnings implement neither real investment nor consumption. They represent the loss of an expansionary force in the economy. On the other hand, such corporatively hoarded funds serve the personal interest of the shareholders by minimizing individual tax under our nonintegrated income taxes. If withdrawal of funds later is desired, partial liquidation of the corporation or the sale of its securities may be had subject to the tax on long-term capital gains.

Corporate shareholders may avoid personal income tax entirely if, during life, no withdrawal of these corporate funds occurs and the corporate securities are not sold.

Private or close corporations dominate numerically the corporate universe. For 1951, of 597,385 corporate income-tax returns (with balance sheets, and with and without net income), 5,854 or approximately 1 percent, had assets of 10 million or more dollars.

Ninety-three percent of the corporations had assets less than $1 million; 88 percent had assets less than $500,000; and 79 percent had assets of less than $250,000.

As of June 30, 1954, the unduplicated number of corporate issuers having securities traded on exchanges, as reported by the Securities and Exchange Commission, totaled 2,588, with an aggregate listing of 3,057 unduplicated issues of stock.

It is perhaps not unrealistic to assume, at the outside, that some 98 percent of our corporations are private in character. These corporations represent many billions of dollars of income, even though outranked in assets and income by the comparatively few giant-size public corporations.

Congress has provided the inducement for personal tax avoidance through the use of the corporation by imposing a steeply progressive schedule of income-tax rates ranging from 20 to 91 percent. Further, Congress, by establishing the long-term capital gains detour, invites the conversion of income into capital gains.

The corporation is a highly useful device for this purpose. In order that the road of income conversion into capital gains be more easily traveled, Congress, in the Internal Revenue Code of 1954, removed certain obstacles to this traffic by substituting the accumulated earnings tax for the former section 102 of the code.

Technically this is found principally in (1) the shift in the burden of proof, in cases of unreasonable accumulation of corporate surplus, from the corporation to the Government, (2) the elimination of the so-called immediacy doctrine, and (3) the establishment of an accumulated earnings credit which serves to reduce the effective rate of penalty tax which previously had been seriously inadequate. In addition, in section 1361 of the code, Congress provides an option to unincorporated business enterprises to be taxed as domestic corporations. This opens the door to proprietorships and partnerships, to join with private corporations and their shareholders, in the conversion of income into capital gains to the extent this may be desired.

The equity of the personal income tax in its burden distribution may be measured, in part, in terms of the extent to which individuals pay tax in correspondence to their incomes under the progressive schedule of rates. Disparate taxation, as found in the differential tax treat-

ment of incomes in the form of salaries and wages and unincorporated business income on the one hand, and corporatively generated income on the other, is seriously violative of the concept of equal tax treatment. These inequalities strike with increased force under present high rates of tax.

Various methods have been proposed which would accomplish some substantial integration of the corporate and personal income taxes. In this respect, it is suggested that the mandatory application of the partnership method to private corporations appears worthy of far more serious consideration than it has received to date.

Under the partnership method private corporations would be relieved of the corporate income tax, with their shareholders including in their individual income-tax returns their proportionate shares of the corporate income or loss, regardless of whether the income had been distributed.

Administrative difficulties appear to render the partnership method impractical for the giant public corporations. Perhaps these are the only corporations which should be regarded as separate taxable entities.

It is time, for tax purposes, to emphasize the basic differences between the private and the public corporation, not their legal similarities. Legal and administrative ingenuity would seem equal to the task of properly classifying private corporations and formulating equitable rules for corporate reporting and shareholder inclusion of corporate income or loss in tax returns.

The closure of an important avenue of tax avoidance and the more equitable distribution of the personal income tax among members of the public would be advantages far outweighing any objections.

Mr. MILLS. Our next panelist is Mr. John Lintner, professor of finance, Harvard University. Professor Lintner.

Mr. LINTNER. The extensive study which my colleagues and I made of the effects of taxes in corporate mergers during the years 1940 through 1947 (see J. Keith Butters, John Lintner, William L. Cary, Effects of Taxation on Corporate Mergers, Boston, Harvard Graduate School of Business Administration, 1951) together with a review of the major changes in tax provisions and the limited information available on the broad characteristics of more recent mergers, leads to five broad conclusions which may be helpful to this committee:

1. Taxes have been a highly significant motivation in the sale of a substantial number of closely held companies, but the role of taxes in this respect has been much more limited than frequently alleged. The tax incentives to sell have been essentially twofold. The first of these tax incentives has been to sell out a closely held business to lessen the impact of the estate tax.

Prior to the Revenue Act of 1950, our field investigations showed that owners without sufficient funds outside their closely held businesses to cover their estate-tax liabilities and other liquidity needs often felt compelled to dispose of part or all of their closely held stock before death, largely because of the probability that redemptions would be treated as dividends subject to high personal income-tax rates. Liquidity considerations, however, were not likely to constitute an important reason for sale for either small companies with assets of less than a million dollars or so (because no single stockholder would generally own enough stock to need to worry greatly

about the impact of the estate tax) or for most large companies having assets of more than $25 million or $30 million (since most of these companies will already have created a market for their securities by selling stock to the public at some earlier stage of their growth). The Revenue Act of 1950 included special relief provisions which considerably reduced these pressures to sell for liquidity reasons, and the relief has been broadened subsequently. The practical effect of these provisions has been to make money distributed in redemptions of stock closely held in estates essentially free of tax. The terms are sufficiently broad to cover a large percentage of the cases in which the need for funds to pay estate taxes would otherwise have exerted strong pressures on owners to sell out.

In addition to liquidity considerations, and often reinforcing them, uncertainty as to the valuation which the Treasury would place on the stock of closely held companies in determining estate-tax liabilities was frequently mentioned in our field interviews as a factor tending to stimulate the sale of such businesses. In general, however, valuation problems have not appeared to be a major reason for the sale of closely held enterprises. The principal reason for the uncertainty on the part of taxpayers regarding valuations is simply that there is no objective test which can be applied to determine the value of such holdings in the absence of trading in the securities of the company in question. Impartial experts often differ by very wide margins in their estimate of the fair market value of such securities, and the evidence we have seen does not justify any conclusion that the Treasury has been deliberately or consistently unfair in its valuations.

The second major tax incentive for the sale of business units has been for owners to sell out a successful closely held business in order to take their profits out of the firm by the capital-gains route as an alternative to having the profits distributed as dividends subject to high individual income-tax rates or left in the company and possibly taxed under section 102, or the new accumulated earnings tax. The capital gains from sales have been taxed at rates of 25 or 26 percent, and where sales take the form of a tax-free exchange of securities the owner can often transfer his holdings into readily marketable securities of high investment quality without incurring any taxes at all on the transaction.

The tax cost ranging from zero to a maximum of 25 or 26 percent of the gain on the sale must be compared with taxes as high as 92 percent under the 1951 act on funds taken out of the business as dividends. High corporate tax rates (and possibly section 102 taxes if earnings are retained) and the personal income tax on dividends have lengthened the time span required for stockholders to diversify their investment position either by building up liquid assets in the company or by taking them out of the company. They thereby have greatly strengthened the incentive for owners of rapidly growing companies to play safe and cash in the gains already attained at capital-gains rates. These motives to sell when opportunity offers have been particularly strong in view of the fact that the market for business firms even in prosperous periods is usually quite "thin" and virtually disappears in depressed periods. The rate increases of the Revenue Acts of 1950 and 1951 substantially augmented this incentive to sell out as did the excess-profits tax of 1950. The more

recent elimination of the excess-profits tax, the reductions in personal income-tax rates, the introduction of the dividend credit and perhaps also the change in the old section 102 have considerably weakened these tax incentives. Since 1954 these tax incentives are probably weaker in any given business situation than they were prior to 1950.

2. As an order of magnitude, taxes appear to have been a major reason for sale in only about one-tenth of all reported mergers and perhaps one-fourth of those involving more than $1 million on the selling side. Tax considerations are more frequently important in sales of larger companies at least up to $25 or $35 million of assets. These fractions, based on our earlier intensive research, appear to be equally representative of mergers consummated during the period 1940–49 and those during the period 1950–54. (Comprehensive information on still more recent mergers is not yet available.)

Income and estate taxes together have probably been somewhat less important in sales of companies of each size—at least up to assets of, say $25 million—in the latter period 1950–54 than in the earlier years covered. But the Federal Trade Commission's recent study of mergers and acquisitions indicates that there were probably relatively more acquisitions of companies having assets of $10 million, and relatively fewer acquisitions of smaller companies in the years 1951 through mid-1954 than in the earlier period. This shift in the distribution of acquired concerns appears to offset the reduced importance of tax motivations in the separate size classes, since tax motives are relatively more important among larger sellers than among smaller companies.

There are two principal reasons why the role of taxes in the sale of business concerns, although important, has been much more limited than frequently alleged. The first is that as previously indicated, the circumstances under which the tax factors themselves will be strong have been much more specialized than has generally been recognized. The second and perhaps more important reason is that nontax motivations have been much more prevalent and frequently far stronger than is often realized. Even when the conditions needed to make tax considerations important are met, they are often overshadowed by such matters as ill health, the desire of an owner-manager to retire, the need to provide for management succession, and a variety of prudent and impelling investment considerations (which incidentally tended to be especially crucial for the owners of the larger selling companies).

3. It appears that taxes are much less frequently of major importance in buyers' decisions to make an acquisition than in sellers' decisions to dispose of their business. While numerous acquisitions involve tax benefits for the buyer which "sweeten" the deal, these tax factors seem to be much more generally overshadowed by nontax motivations for the acquisition than is the case on the sellers' side. As example of the considerations which we found often far outweighed any tax benefits in the decision to acquire another company rather than to build a new plant or develop a new product independently, I might mention the substantial saving in time and lessening of investment and market risks obtained by using the merger route; the opportunities during most of the period since 1940 to acquire needed productive

capacity at bargain prices by purchasing the securities of other companies which have been selling at prices quite low in relation to current asset values; and the advantages of our entering a new market in the preferred position of an established competitor as well as the advantages of avoiding the many obstacles and necessarily intensified competition that would be involved in any attempt to break into a new line or area in competition with all existing firms.

4. While tax considerations are thus of limited importance in most decisions whether or not to merge, they are very frequently of paramount importance for both buyers and sellers in determining the form of the transaction—in other words, how to merge.

5. The limited importance of tax considerations in decisions whether or not to merge suggests that the interpretation of the provisions and the effectiveness of the administration and enforcement of the antitrust laws, particularly the recent revision of section 7 of the Clayton Act, is more important from the standpoint of maintaining and strengthening the competitive structure and processes of the economy than any changes in the provisions and administration of the tax law and regulations.

Mr. MILLS. On behalf of the subcommittee, I want first to thank each of you for your appearance today and the contribution you have made in your papers contained in the compendium and your summaries of those papers here today.

We appreciate your taking the time to be with us.

In focusing this afternoon on the problems of taxation of small and new businesses, I think we are fortunate in that we can base one discussion on virtually unanimous agreement by everyone, that a prime objective of public policy in a free enterprise economy is to strengthen as best we can the competive position of such businesses.

Is there a favorable reaction to that conclusion, on your part, Mr. Adelman?

Mr. ADELMAN. If I understand correctly; yes.

Mr. MILLS. I think you do, on the basis of your "Yes" answer.

Two of our panelists, Professor Adelman and Professor Lintner have suggested that the Federal tax laws have not had an appreciable effect on this competitive position. Have I properly interpreted your paper?

Mr. ADELMAN. I was making a plea of my own ignorance, Mr. Mills, that I didn't know whether or not they had any substantial effect.

Mr. MILLS. You haven't found that they have had any substantial effect?

Mr. ADELMAN. I wouldn't say that, no.

Mr. MILLS. Have I properly interpreted your paper?

Mr. LINTNER. I think I would word it that tax considerations have been an important consideration in the sale of many small-business firms that might otherwise have continued as independent enterprises; but that these effects are considerably more restricted than frequently alleged. The importance of tax considerations through mergers is considerably less than that of other aspects of public policy.

Mr. MILLS. Have you found whether or not tax policy has made it impossible for these that have been sold to continue on their own?

Mr. LINTNER. It would be a relatively small fraction, a quite small fraction of cases in which tax considerations were even approaching a level where it was impossible to maintain the busines, but I would like to elaborate one aspect of that. The kind of small business that I think many of us are particularly interested in is the small business that has the vigor and the potentiality for growth to offer an effective challenge to the larger corporation, and in the earlier studies that Professor Butters and I have made, we found that the corporate tax structure particularly had a very important effect on the opportunities for such companies to grow and offer more effective competition to larger companies.

Mr. MILLS. Mr. Cohen, as I understand your paper, you urge certain revisions of the law which you feel would make a positive contribution toward stimulating new ventures.

Mr. COHEN. Yes, sir.

Mr. MILLS. And Dr. Hall, you draw our attention to what you regard as weaknesses in the law which encourage individuals to use corporate entities as a tax avoidance device, a problem which you identify as restricted largely to the private corporation.

Have I interpreted your paper properly?

Mr. HALL. That is correct.

I think in addition it can be said that in the interest of serving more adequately the principle of equity, it is worthwhile to consider the possibility of taxing the private corporations as partnerships.

Mr. MILLS. Well, if that is a proper understanding at this point of the papers that you have turned in, I think these papers then focus on the major aspects of the problem for panel discussion this afternoon in a very satisfactory manner.

Now, I have a question that I would like to direct to Professor Adelman and Professor Lintner, and I might say you have in part answered it in your summaries today. In recent months, as you know our attention has been called to a rising wave of mergers of corporate enterprises. This has been attributed by some to the tax inducements afforded by the tax law regarding loss carryovers, and reorganizations.

Can you offer us any information as to the kind of companies, public or private, and the size of companies which have preponderantly been involved in these mergers? To what extent, do you know, have tax considerations been an important factor in these mergers? Dr. Lintner, you have already discussed, in part, that question. If you will lead off?

Mr. LINTNER. The latter part of your question is covered, I think, in the paper to the extent that I can answer. On the basis of the fieldwork, we found what kind of tax considerations had been playing a part earlier. We know the general changes in the tax law, and those would seem to indicate that the loss carryovers are less important than the nontax consideration in most of these acquisitions.

Mr. MILLS. May I interrupt you at that point?

As I remember in your paper you brought us up through 1947; did you not?

Mr. LINTNER. The fieldwork in our major study of this problem, which was carried through in 1948 and 1949 and published in 1951, covered mergers that occurred between 1940 and 1947. The inferences that I drew in the prepared statement were based on the information regarding the size classes and other characteristics of mergers

since that has been recently published by the Federal Trade Commission, together with the general changes in the tax law.

Mr. MILLS. That is mergers even in recent months?

Mr. LINTNER. The information that has been published by the Federal Trade Commission, and the only information at least that I have at hand, is the report on corporate mergers and acquisitions, published by the Federal Trade Commission, in May 1955, which covers mergers up through the middle of 1954. I have no further information on mergers since that time other than a newspaper notice that the total number of mergers, estimated for the year ending 1955, was about 500; but there was no detailed breakdown.

Mr. MILLS. Are the size and kind of these companies comparable to the findings you reached based upon 1940–47 studies?

Mr. LINTNER. The only information with respect to size for mergers in 1955 gives a classification of the proportion of all acquisitions made by companies of different size on the buying side. It is in terms of very broad groups, and that information incidentally is provided in the larger report for the mergers, 1950 through 1954. The only information—and I would like to emphasize this if I may—even for 1950–54 the only information available with respect to the size of the companies acquired is based on a relatively small sample of mergers occurring in those years, even in the published document. As the earlier research that Professor Butters and I did, brought out very clearly—and I would be glad to supply copies if the committee should desire—it is absolutely necessary to have the industry classification and the size of both the acquiring and acquired company in order to be able to draw solid conclusions regarding the effects of mergers on competitive structure, and competitive behavior. You will generally need other information as well, but if you have a detailed industry breakdown and knowledge of size on both sides of the transaction, you can frequently obtain the other information to draw some pretty good conclusions. Lacking information on any detailed industry breakdown, of the industry of the acquired companies, and the size of the acquired companies, I am afraid that I will be able to offer little more on this point this afternoon.

Mr. MILLS. Let us aproach it then in broader terms.

First of all, do your studies lead you to any conclusions with respect to the benefit, or lack of benefit, that the economy may derive from a growing number of mergers, year after year? Is it a wholesome thing? Is it in the interest of economic growth, in the interest of our economy, for these mergers to increase in number year by year?

Mr. LINTNER. I would not like to see any substantial increase in the volume of mergers, especially in the number of acquisitions by larger firms within their own industry. At least some of these mergers are probably undesirable, but the information is not available now to say how many of these cases there are, let alone how many are undesirable.

I would like to mention at this point, however, one feature of the problem which sometimes gets overlooked. One of the factors that is frequently important in a businessman's mind when he is forming his initial decision whether or not to go into business—beyond what sort of a profit he can make and how successful he will be in that business—is what the opportunities will be to sell the business

to others after he has developed it. The market for businesses, in other words, is one of the markets in a free-enterprise economy that does encourage the formation of new firms. Shut off these markets entirely, and you remove one part of the incentives for new businesses to be formed.

I want to keep this point in perspective. I do think this is worth bringing out as one favorable aspect of mergers that very frequently is overlooked, and it is one of the things that the framing of a wise public policy must keep in mind; but I do not think that that requires a booming high rate of mergers occurring at all times, and I do want to emphasize that this is by no means the only consideration to be taken into account in framing public policy on merger .

Mr. MILLS. I am concerned frankly over the rate of mergers. I am concerned, therefore, over whether or not existing tax structure is too conducive to merger, and I am also interested in whether tax policy for economic growth and stability should be so couched as to offer fewer inducements to merger.

Mr. LINTNER. I think that is on one other point in your comment——

Mr. MILLS. In the course of your reply, would you comment on my observation?

Mr. LINTNER. Yes. We do have some solid statistical information regarding the effects of the mergers that were occuring from 1940 to 1947 which were widely said to have had great effects upon the concentration and competitive structure. In terms of broadly defined industries, and for all manufacturing and mining, there was an increase in concentration from those mergers, as would be expected.

When we measured it, regardless of which 1 of 3 different measures you would prefer to use, we found the increase was relatively small—far smaller for instance than the changes that probably arose from the differences in the relative volume of retained earnings in different sized classes of various other aspects of the policy.

In short, we did make a careful, very time consuming and expensive study, digging out ourselves all of this asset information whose importance I have emphasized earlier. We found concentration had been increased, but only moderately, if you were talking about broadly defined industry groups or overall manufacturing. However, the change was fairly substantial within food and textiles, and in some of the more narrowly defined industries, very substantial.

Mr. MILLS. You and I can understand and visualize many instances where merger can occur for strictly a business reason, aside from any tax advantage at all, or aside from any desire to obtain any advantage tax-wise.

For example, a chemical company might well decide that it needs within its framework the subsidiary operations of a petroleum company, and a merger of that sort can occur. We can understand why it can occur but I fear that in instances of merger, there are cases where there is some advantage, either to the seller, or to the purchaser, taxwise, that prompts the merger rather than purely business reasons.

Now, what I am getting at is this: Should tax policy for economic growth permit opportunities or inducement to mergers of that sort where there is no real business reason back of the merger?

Mr. LINTNER. I would certainly agree that it should not do so where there is no real business reason, but the problem is a very difficult

one. As I point out in my prepared statement, the estate-tax pressure on individuals to sell out closely held businesses has largely been taken care of by changes already made in the tax law. The effects of the corporate rate and the progressive personal income-tax rates are the large positive pressure on sellers at the present time, where tax motivations are important in decisions to sell. But our revenue requirements are such that I doubt that either can be reduced very greatly. I might also add on the basis of all our research that these tax pressures from the personal income tax and the corporate income tax on the selling side appear to be a much more important tax consideration in mergers than any tax considerations on the buying side. Consequently, while I agree with your position as you have stated it, I find the problem rather difficult to move from that point; yes, taxes do lead to some mergers that otherwise wouldn't occur and we might be happier if they didn't occur, but the principal things involved in the present tax structure, as we understand the situation now, are the personal income tax and the corporate income tax, and these account for most of our total tax revenue.

I might add in passing that requiring corporations to file under the partnership method, on the mandatory basis that Professor Hall has suggested, would substantially augment these tax motives to sell in probably a very substantial number of cases. The personal tax is progressive, and reaches relatively high rates pretty quickly—especially in terms of the kind of incomes that will be produced by the small firm, with a vigorous enterprising management that has a hot idea, and is going all out to do something with it.

The application of high progressive personal income taxes, such as we have now, to the income of such companies—and these account for most of the closely held small businesses that are sold out for tax reasons—seems very unwise to me. To apply the partnership method, which really means to apply personal income-tax rates on a compulsory basis, I think would have very serious implications with respect to the kind of objective that you have just stated, and would hinder their growth and investment.

Perhaps Professor Hall would like to comment on that.

Mr. MILLS. Yes; I want the comment of the other members of the panel if I may have it on the discussion to this point.

Mr. HALL. Mr. Mills, I suspect that what Professor Lintner suggested would be true certainly in a number of cases.

It is pretty difficult to quantify the effect of the application of the partnership method of taxation to the private corporation in terms of its serving as an inducement for the sale of the private corporation.

At the best perhaps we could no more than suggest a guess as to what the effect would be. I may say that personally, I would not be particularly concerned with the extent to which there would be a positive merger inducement.

I think that I would agree that in some instances, you would get such an inducement, but on the other hand, the partnership method of taxation as applied to the private corporation has certain advantages for the owner apart from the fact that income whether or not distributed would be subject to the personal rates; it would be possible, for example, for the owners of a private corporation to offset losses of the corporation—the private corporation, against other income.

That would be beneficial, it would improve, I take it, the quality of risk capital and possibly the volume. We can't be entirely certain about that, but in general I think it would be on the positive side as to risk capital improvement quantitatively and qualitatively.

The establishment of a more neutral system of taxation, or one where tax inducements are less effective in pushing or in restraining corporations toward or from merging by removing present disparities in the taxation of the income of private corporations, as compared with business income generated through the noncorporate form, for example, partnerships and proprietorships, would seem to me desirable. I believe it would be in the public interest to minimize tax influences, insofar as practicable, on corporate competition, corporate mergers, and corporate size. To the extent that you get greater tax neutrality by subjecting private corporations to partnership taxation, under income tax, the initial shock of the tax readjustment may cause a few private corporations to move toward merger. In other instances it may result in the retention of the corporation by the present owners rather than in a disposition to merge or to sell. I think it would have both effects.

I am not sure we can measure usefully at this time what the net effect on balance would be.

Mr. MILLS. Mr. Cohen, do you care to comment on our question and the answers of the panel?

Mr. COHEN. As a lawyer, sir, I speak with deference on matters of economics. I must say, having heard Mr. Lintner and Mr. Hall discuss Mr. Hall's proposal for mandatory partnership treatment of the closely held corporation, I would feel that while it has a logical advantage and would equalize tax treatment between those who are sole proprietors, partners, or stockholders of smaller corporations, it seems to me that it would greatly increase the competitive advantage of the large publicly held corporation.

Take a simple case of say, two department stores in the same town that are on the same block or adjoining.

One of them is a branch of a large national chain, publicly held, with the stock listed on the stock exchange, and having a maximum tax rate, then, of 52 percent.

The other one may be owned by a family, and if it has the same income, may find that the average income in the business is taxed at 80 percent. It would seem to me that this would put the large corporation at a competitive advantage as against the closely held one.

Mr. MILLS. Which may be the smaller one?

Mr. COHEN. Which may be the smaller one.

The individual income-tax bracket of a married individual reaches the 52-percent mark somewhere, say, around $40,000 of income in the current tax structure, and if the privately held department store happens to have a good year that year, the income for the individual can easily go over $40,000. This may not be his take-home cash. It may be invested in inventories and new furniture and fixtures and improvements to the business. But the large corporation could take the 48 percent remaining after the payment of its tax and reinvest the money in the same fixtures in a preferred tax position.

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For that reason, from the economic standpoint, I would think mandatory partnership treatment would be of advantage to the large companies and tend to force mergers.

I might say too that on the more legalistic side, with which I am more familiar, I have spent time with a number of persons in the tax field endeavoring to sketch out a method of mandatory partnership tax treatment. The technical difficulties involved in this should not be minimized. They are extreme. You are, I know, aware of the difficulties involved in the restatement of the rules of partnership taxation in the 1954 Revenue Code and if they were extended to half a million corporations generally the technical legal problems would be extreme.

If I might make one further comment on the economic facts of the situation that might from a tax standpoint force sales of closely held corporations, I think the problem is as Mr. Lintner said, a question of trying to weigh the advantages of logical taxation of corporate income with some of the considerations of expediency that might be necessary if you want to prevent, or minimize the trend toward mergers.

If there is a real tax reason today for the owners of a closely held company to sell out, it may be—I think it is largely—the fact that they cannot take any funds, any substantial amount of funds, out of the corporation without prohibitive surtaxes.

The corporation will pay a 52-percent tax. The money may remain in the company, but the individuals cannot take cash out of the company without paying large individual surtax on the dividend.

Now when a sale is made, it can be made by a tax-free merger without any tax, or it can be made at a 25-percent capital gains tax on the profit.

The problem is whether or not it would be wise to reduce the premium which now exists in favor of merger in such a situation by permitting the stockholders of the company to withdraw funds at some lower rate than the present top surtax brackets.

I have often thought that perhaps if we reduced the ceiling rate on dividends from closely held companies, we might in that way encourage the private owners to retain their private ownership, rather than sell out on a tax-free gasis or capital-gains basis. I am not sure that the amount of revenue which the Government gets out of dividends from closely held companies is substantial enough to insist upon the high surtax rates running up to 91 percent.

I have never seen statistics as to how much revenue is derived from dividends out of closely held companies.

The present rules tend to minimize those dividends, because the taxes are prohibitive. I believe that the result is by and large that the dividends are not paid, and companies are sold and merged, rather than the Treasury getting a substantial revenue out of such dividends.

I do not know whether those statistics are available but I think it would be of great assistanct to the framing of a tax policy if we knew how much is actually received by way of dividends from closely held companies.

Mr. Mills. Mr. Cohen, I appreciate your thinking.

I have always had some difficulty going along with the idea that when we find in tax structure some inducement, which I think frankly

is there, for merger, that the way to prevent the merger in the first place is to undo something else.

That does not make necessary then the procedures that are followed for tax advantage through merger if that is the case, and that leads me to a question that I intended to ask you later with respect to your example in your summary of your paper for us today: everyone recognizes that the corporate form has many tax advantages. In turn, our tax laws have imposed certain restrictions upon those who make use of these tax advantages. It is not just a one-way street, but there are two sides.

Now, let's take your example as a case in point, that this thing is two-sided: would you say that Smith is attempting to enjoy the advantages and at the same time avoid the price of the corporate form in the example you give?

Mr. COHEN. Well, I think that you can easily say that.

Mr. MILLS. Do you solve anything? Do you solve anything in permanent tax policy by the establishment of these one-way streets?

I think we have too many of them already.

Mr. COHEN. I think we do. I think they exist in this very field as well. I think the basic pleas that I make in my paper, Mr. Mills, is that the doubts and ambiguities in the field be eliminated. I think the second question is what the answers should be, but I do feel that we should first of all see if we can't make whatever answer we want rather definite.

Mr. MILLS. With all due deference to you, and I know you are the lawyer, I have merely studied law, but it just occurred to me that in your example you are trying to put Smith in a better position than he would be in if you had no tax law at all.

What is the venture, what is the risk?

The free-enterprise system still should provide for venture and risk in venture; should it not?

Mr. COHEN. Yes.

Mr. MILLS. Let's not let that out, as we advance with the study of tax policy for economic growth and stability.

Mr. COHEN. I think that you are directing your question, if I correctly understand it, to the suggestion that the losses be allowed as ordinary deductions whereas the sale of the stock be allowed as a capital gain.

I am not sure that that is an advisable thing to do, unless you do want to foster the flow of capital into small and new business as we have done in other situations. We have certainly done it in the oil and natural-resource industries. That, I think, is just fundamentally a matter of policy.

The other part of the suggestion that I make though is, I think, not one which can be characterized as such.

The question whether Mr. Smith should be allowed to recover a part of his investment before an ultimate sale or liquidation of the business is not one which would be different from that which we would have if there were no tax structure at all.

If there were no taxes he would put his money in and as the money were made he could be repaid part of his investment, either by way of repayment of notes, or by way of preferred stock.

The other part of the suggestion about the deductibility of losses relates to trying to encourage such investments.

You have that situation with respect to corporate investors now. You have that situation with respect to persons who are able to fit within the category of being engaged in the business of financing corporations.

Should we draw the line there and say that corporations and those who are financiers can get this advantage, but those who are casual lenders cannot get the advantage? I would go with you in your comment, if you would withdraw this privilege from the whole category, but I would not draw the line where it is drawn today.

Mr. MILLS. Not getting out of our own depth, namely the law, let's see if you will agree with me that any tax policy for economic growth and stability should provide for equity investment.

Mr. COHEN. Yes.

Mr. MILLS. Then I will ask you this question: Do you believe that your proposal would encourage or discourage equity investment?

Bear in mind now what you are suggesting.

You want Smith to invest only $5,000 and remain a creditor with respect to $75,000.

Mr. COHEN. I personally would prefer the rules——

Mr. MILLS. I am sorry, it is $95,000; I said $75,000.

Mr. COHEN. I understand.

Mr. MILLS. I meant $95,000.

Mr. COHEN. Personally, if I were starting from scratch in drafting such a program, I would prefer to give the same treatment to the equity investment that I would give to the debt structure.

Mr. MILLS. How would you do that?

Mr. COHEN. I think that you would simply equate stock and debt in this area by the provisions that you would put into the tax law.

For example, in the first aspect of the problem, with respect to the return of money to Smith, if the venture is successful, I would like to see the provision worked out so that preferred stock could be used to return the money to Smith, as well as to cover the question of "thin incorporation" if debt were used.

I would agree it would be more beneficial to the company if it could finance in this fashion with preferred stock rather than with debt.

As to the second part about the losses, I am starting on the premise of the present tax law which already differentiates between stock and debt, and then further differentiates between business bad debts and nonbusiness bad debts.

I would like in this area to see the definition of business and nonbusiness changed so as to equate lenders who are on, I think, the same basis in this field.

I would go further if the Congress would, and say it would be logical enough to give the same treatment with respect at least to preferred stock.

Mr. MILLS. Mr. Cohen, please do not misunderstand the tenor of my questions. I am not at all unsympathetic to your basic objective, namely, facilitating the financing and establishing of new businesses.

I merely wonder whether or not your example has placed the problem in proper focus and it is only because of that that I raise these questions.

Mr. COHEN. Well, I use this example of a $5,000 common-stock investment and $95,000 of notes simply to illustrate the thin incorporation problem that exists today.

I would not recommend that type of capitalization for a company. I would——

Mr. MILLS. I am sure you would not.

Mr. COHEN. I would certainly prefer it otherwise. But I do not know how you would precisely capitalize such a company under the present tax laws and I doubt that anyone else does today.

No one today knows exactly what the capital structure should be to give the maximum tax benefits to Smith, the prospective investor here.

Mr. MILLS. Let's permit Professor Adelman, if he will, to comment on the question I asked some 45 minutes ago of the other members of the panel, whether or not you have any information with respect to mergers in recent months that would give us any information as to the size and character of the companies that merged? What I am trying to get is this: Are the companies related in business activities with the merged company, are they small or large, medium sized, or very small?

Mr. ADELMAN. I would answer by way of altering just a little bit what Mr. Lintner said.

He may agree with me, that until you have the industry by industry breakdown of mergers, the size of the acquiring firm, and the size of the acquired, not only can you not reach any solid conclusion as to the importance and the impact of the mergers, but you cannot reach any conclusion whatever, and I would say that right now we are completely in the dark as to whether mergers are of the slightest importance or of considerable importance.

We just do not know.

Now the Federal Trade Commission study that Mr. Lintner referred to made a good beginning on that kind of a study, but in its present form it resembles a detective story with the last two chapters cut out.

All that has gone before leads up to a climax that is not there. I find it difficult to understand, if I may say so, why Congress, which appears to take some interest in the matter, does not give the Commission the directive and the funds to finish up the job.

Until they do or somebody else does it, we are pretty much operating or talking in a vacuum.

Mr. LINTNER. Mr. Mills, perhaps I should add here that Mr. Adelman has very effectively stated what I had in mind. I cited our intensive work on the earlier mergers—showing some increases in concentration, but generally small ones, after we got the data on the size of the companies acquired—merely as indicating by example how important it was to have all of this information. As I tried to say before, and as is clear from my prepared statement, I am not in a position to say whether concentration, overall or within broad groups, has been increased or not, and if so whether greatly or not, in the present situation.

I was merely citing our earlier work as indicating that the necessary information is obtainable if you are willing to put in the effort and expense required to get it. You just do not know until you have all of the facts, and it is important to get them.

Mr. MILLS. Can we agree that it is a matter about which the Congress should pay attention?

Mr. LINTNER. Beyond any question. I would like to endorse completely Mr. Adelman's plea that everything be done to provide the funds and encourage detailed, careful, comprehensive studies in this area.

Mr. MILLS. Suppose that we find there has been a steady increase since 1947 in mergers?

Would you suggest that the Congress should do something about it?

Mr. ADELMAN. Is the question addressed to me?

Mr. MILLS. Yes; either you or Professor Lintner.

Mr. LINTNER. My own reaction would be that knowing what mergers are occurring between firms of what size classes, in what industries, is far more important than simply knowing the total number, whether it is 500, or 200.

The important thing is who is doing what, with whom, in what markets.

Mr. MILLS. That is a matter about which the Congress should be concerned, if that case happened?

Mr. LINTNER. Yes, sir.

Mr. MILLS. Dr. Hall, you suggest that we should recognize for tax purposes the distinction between private and public corporations.

I take it you think the distinction is that the private corporation in fact is merely an agency, or extension of the individual shareholders, whereas the public corporation is properly regarded as a separate economic entity, distinct from the shareholder; is that your thinking?

Mr. HALL. Substantially.

Mr. MILLS. If we accept that distinction, would it indicate that in the case of the private corporation there is the double taxation of earnings we heard so much about in connection with the dividend provisions in the 1954 Code, whereas this double taxation, at least from the individual shareholder's point of view, does not apply in the case of public corporations?

Mr. HALL. I am not sure I understand entirely the latter part of that statement.

Mr. MILLS. You remember that we included in the 1954 Code a provision for dividend credit.

Mr. HALL. Right.

Mr. MILLS. Dividend receipt.

Mr. HALL. Partial relief has been provided. It is a very modest amount.

Mr. MILLS. If we follow your philosophy of separating for tax purposes corporations into either private corporations or public corporations, namely, the private corporation being merely an agency for stockholder purposes, and the public corporation retaining its entity actually for stockholder purposes, my question is this: Should the dividend received credit only apply to those private corporations that you recognize as being merely an agency of the stockholders?

Mr. HALL. I should like to see a somewhat different approach to the problem rather than working through the dividend relief provisions, both the exclusion provision and the tax credit provision, which I think will only create difficulties the further we go in extending these credits.

The private corporation should be viewed for tax purposes for what it is, namely, an incorporated proprietorship or partnership.

It should be taxed as a partnership, or as a proprietorship, even though it has the corporate cloak around it.

Mr. MILLS. Permit me to interrupt you at that point so I can get some understanding of what you mean by private and public.

I assume you view them with respect to size.

Is that one of the determining factors or do you view them in this light?

Sometimes we refer to a small business as being that business which cannot, or does not have a full-time office in Washington. You perhaps have some other basis for making the distinction.

Mr. HALL. I think my distinction might result in the same conclusion. However, it is the identity between ownership and control which I think permits us to separate the private corporation from the public corporation.

Mr. MILLS. I thought maybe you were trying to reach some distinction between businesses on the basis of size and I thought maybe it might help us with our own definition of what we mean by small business.

Mr. HALL. I think there is a size relationship as between the public and the private corporation as indicated in my paper.

Generally speaking, we find that the smaller corporations assetwise tend to be private corporations, and our giant-size corporations customarily are public.

On the other hand, we have at the present time a giant-sized company such as the Ford Motor Co. which would not be classified as a public corporation.

There are other corporations of giant size where we can find substantial identity between ownership and control. In general, the larger the corporation in asset size, subject to recognized exceptions, the more likely it is to be a public corporation.

Mr. MILLS. Dr. Hall, while I have your attention—would you help me with this point?

Give me your understanding of the distinction between a small business and the business you refer to as a device the shareholder may use to avoid the payment of taxes in the hands of the shareholder.

What did you call that latter type of operation?

Mr. HALL. Again I am not entirely certain to what you refer. Of course, the avoidance device in the use of a corporation, when you control it—I mean where the corporation is responsive——

Mr. MILLS. I am sorry, I said small business. I am referring to small corporations.

Mr. HALL. The private corporation.

Mr. MILLS. Yes.

Mr. HALL. The avoidance technique of course is to take income out in the form of a capital gain if you require or want the income, rather than take it out as a regular distribution subject to the present rates of income tax, or if you do not need the income, and we can find instances of this sort, you avoid personal tax entirely and you simply hand down your corporation, with its assets, including the retained earnings (which have gone to build up the assets) to the second generation, the successor generation.

This means that individuals through the use of the corporate device are avoiding the personal tax.

In extreme cases they avoid it entirely. This result seems to me not to serve the interests of equity in the distribution of the income tax between and among members of the public.

In the taxation of private corporations as partnerships this would not occur. Current tax contributions would then be in conformity with individual income.

Mr. MILLS. What would the panel have to say about this as a possibility—I merely throw it out, not to commit myself to it or anything else.

Suppose we were to eliminate the individual credit for dividends received, substitute for it a deduction by the corporation for the dividends it pays out, in some satisfactory manner to avoid the difficulty we were once in with the old retained earnings proposition.

Then treat transfers of property by gift or death as constructive realizations, perhaps with some averaging device for any gains brought into the tax account.

What would be the effect?

Mr. HALL. You would have partial income-tax integration. I would say that this is better than continuing as we are. On the other hand it seems to me that a partial method of integration is only a palliative and fails to meet head on the principal problem.

On the basis of your suggestion, Mr. Mills, corporations would be taxed only on their undistributed earnings.

Their distributed earnings presumably would be subject only to the individual tax. Corporations would get a tax credit. Subsequent distributions would be realizations, and I take it would be fully taxable.

Mr. MILLS. Yes.

Mr. HALL. This would be better I think in terms of establishing greater tax equity than what we now have but my dissent with reference to the method would be that it does not go far enough.

I think the job has larger dimensions than would be recognized by this approach. The very high rates of Federal taxation combined with State and local taxation causes the problem of equality in the tax treatment of different members of the public to become of supreme importance. It seems to me that the Government has a responsibility under this very high level of taxation of seeing that the burden of Government, the financial cost, is distributed as equitably as possible. This is why a method of partial integration leaves me unsatisfied.

It would be a step forward, but I should like to take a larger step—full tax integration.

Mr. MILLS. Do any of the other members of the panel desire to comment on that particular question?

Professor Lintner?

Mr. LINTNER. I might comment that I think that equity considerations are all in favor of your suggestion with respect to realization at time of gift or death.

The dividend credit to the corporation I think is—so far as equity between people is concerned—a more equitable means of handling the problem of nonintegration and double taxation that we have now than the provisions brought into the 1954 code but I would suggest that the revenue implications of anything approaching a full credit for

dividends paid could be large. Offhand it might me 2 or 3 times as large as any budget surplus I have yet heard suggested as possible this year. Also, smaller companies depend more heavily on retained earnings for growth and investments, so that between corporations——

Mr. MILLS. If you will pardon the interruption at that point, would the complete elimination of dividends paid by corporations from the corporate tax amount to as much in revenue as the present dividend-received credit carried to its ultimate goal, as stated by someone who was in Congress at the time it was being considered, from 4 to 100 percent?

Mr. LINTNER. I could not give an answer without some figuring on that one.

Mr. MILLS. I do not mean that was the view shared by everyone who voted for it, but it was said at the time by some who supported it that they would like to see the dividend-received credit extended from 4 percent in time as Treasury conditions would permit to 100 percent.

Mr. CURTIS. May I interject one thing, and actually the original plan did have a progression.

Mr. LINTNER. In view of the very large fraction of dividend received by people with large amounts of otherwise taxable income, I should think that it is quite possible that the proposal you suggested as having been considered or at least in the minds of some, would involve still greater revenue losses.

It would depend very much on the particular rates involved and I would have to do some pencil work before I could give you the figure.

Mr. MILLS. I don't want to state as a positive fact there would be less revenue loss to the Treasury involved from the proposal to exempt the corporate dividend paid out than a hundred percent application of the dividend-received credit, but it is my recollection that there would be less revenue lost.

Mr. LINTNER. I think it is very possible in view of the very large fraction of dividends received in upper income groups.

Mr. MILLS. Let me go then to Mr. Cohen, if I may, with respect to our question addressed to Professor Hall and on which Professor Lintner has commented.

Do you care to make any comments?

Mr. COHEN. The dividends paid——

Mr. MILLS. Treatment of transfers, due to gift or death?

Mr. COHEN. Mr. Chairman, I have been trying to think, as these gentlemen have discussed the matter, as to the relative positions of different corporations that may be in competition with each other under such a system.

It occurs to me that the larger well-capitalized company with plenty of equity capital may be in a position to distribute its earnings and dividends with greater ease and facility than can the smaller, struggling competitor, which is in dire need of capital.

I believe one of the difficulties that we have experienced under the undistributed profits tax, particularly in 1936 and 1937, was the very difficult question of whether to allow some relief to a company which has to retain its earnings to retire debt or retire preferred stock, or to a company which has a deficit from prior losses, and cases of that kind. I think you do not have to consider many cases before you are convinced that there is a need for some relief for companies that either are not in a position to pay dividends, or are not in position

to raise money for their capital requirements by issuing stock to the public or borrowing from banks or insurance companies. Once you start to provide credits for relief cases, then it seems to me you do not have a flat rate of tax.

There is then not a competitive tax structure from business to business.

I think there is an advantage in our business system in trying to get large and small business on at least an equal basis from a tax standpoint in their competitive operation.

That is the thing I fear in Mr. Hall's proposal.

I have the same fear with respect to this one.

Mr. MILLS. I am merely throwing that out, you understand.

Mr. COHEN. Yes. I am just answering offhand.

Mr. MILLS. I recognize the difficulties that are inherent in any suggestion of this sort, when you get not only into the area of undistributed profits but also when you view the suggestions from the point of view of whether you make it easier for capital to be obtained by larger companies than smaller companies.

I recognize that there might be some inducement on the part of those of the larger corporations which are pretty heavily endowed with earnings at the present time to use some device of this sort to the disadvantage perhaps of small companies.

I recognize there is that possibility. I do not say it exists, but there may be some elements of danger there. That is the reason I threw it out.

Pardon me. Go ahead.

Mr. COHEN. I was just going to speak for a moment with reference to the second part of the suggestion of making any transfer by gift or of taxable realization.

I think you might distinguish between the case in which the interest being given away represents, say, the controlling interest in a business corporation and the case of a real estate or other investment which does not represent a controlling interest in a competitive business situation.

I personally am in favor of high estate taxes, but I would point out that increasing the burden of estate tax with respect to a business interest does tend to force mergers and sales.

I am not sure that there would be an advantage from this standpoint in increasing the death tax burden on such interests—and I think this is in effect a form of tax that is occasioned by death. It may not be under the heading of a death duty but it is occasioned by death. You are increasing the burden that arises at time of death.

Mr. MILLS. Or gift?

Mr. COHEN. Or by a gift—a gift being a controllable situation and a death not.

It is an increase in the burden that falls upon a family desiring to retain the control of the company following the death of the principal owner.

I would be inclined to try to avoid an increase with respect to that type of situation, or at least allow some means of solving it by payment of the tax over a longer period of time.

I think that perhaps as good a case can be made for continuing the old basis of the investment in the hands of the donees, or the lega-

tees, as for forcing the payment of a capital-gains tax upon a transfer which does not bring cash into the family.

Mr. MILLS. Mr. Cohen, may I change the tenor of our discussion just a little bit, unless, Professor Adelman, you desire to comment on this point?

Do you?

Mr. ADELMAN. I think in general we have a conflict between equity considerations and others and these conflicts tend to get acute when tax rates are very high.

I would be sympathetic to integration of the corporate and the individual tax, but it does serve in effect as a tax on retained earnings, and as such it bears harder upon the smaller firm, particularly the one with potentialities for growth and for exerting some significant competitive pressure. To that extent I think its effects are undesirable.

Now there is no real solution to this problem of equity versus other policies. Palliatives are about the only thing we can offer, so perhaps we should not speak too scornfully of them.

Mr. LINTNER. In this connection I would like to comment that the discussion turned to others before I had commented on other than the revenue and equity parts of this proposal.

There is clear evidence in the earlier studies that Professor Butters and I made that this would probably have several undesirable competitive effects, especially on the investment opportunities and rates of growth of particularly the more energetic small firms which are the important ones who can offer a significant challenge to the larger ones. The public-policy problem here—as in connection with Professor Hall's proposal and most other aspects of tax policy—is a balancing of how much equity you are willing to give up in what ways to what groups in order to gain what advantages in terms of greater opportunities for growth, higher rates of investment, more vigorous competition, and so forth. These considerations, as well as revenues cost and fiscal effects, are all tied up together.

Mr. MILLS. Let me change the discussion just a moment.

In spite of the findings which your study proposes, Mr. Lintner has led you to conclude, and Professor Adelman, I am convinced in my own mind that the present tax structure is a greater deterrent to growth in new and small businesses than in old businesses of long duration, and I cannot avoid that conclusion when I consider the fact that the older businesses have had opportunities for growth and accumulations during periods when the tax rate on corporations was lower than it is today when the newer and smaller businesses are trying to grow, and I think that in and of itself is almost axiomatic.

I am not unmindful of the fact either, Mr. Cohen, nor, I am sure, are you, that there are many provisions of the present code not written in 1954 necessarily, but carried over from years past, that act to convert what might otherwise be normal income in the hands of a corporation to a capital gain for the benefit of corporations that can utilize those differentials in the tax law.

I find too often that it is not possible for the new business, or for the small business to utilize those differentials as fully as the old, long-established business which may now be large, and I have no objection to large business. It is not that.

I merely want to recognize a situation, if it exists, which may prevent the small business from becoming large.

In the opening session of this study, Mr. Dexter Keezer, who is with McGraw-Hill publications, called our attention to the fact that his studies of prospective capital outlays by business indicated that the present tax structure was not deterring outlays for expansion, growth, and so forth, by the larger businesses in the country, but that the existing tax structure was very definitely preventing the accumulation of capital by small and new businesses that could be utilized for additional capital outlay, for expansion and growth purposes.

That is based upon a recent study that he has made, following inquiries directed to business executives presumably.

I understood that from his statement.

Did you not get that impression?

Mr. CURTIS. Yes.

Mr. MILLS. Now, then, there must be something about its tax structure that prevents the opportunity for accumulations by small business, to the extent that accumulations may occur in the hands of larger business. If that is the case, whatever it is about the present tax structure should be changed as a part of tax policy for the future if we are to promote economic growth and stability; is that right?

Mr. LINTNER. May I comment on that?

If I understood you, you were saying at the first of your remarks just now that "in contrast to the findings" of the studies I had made. I would like to clarify that.

Mr. MILLS. Please.

Mr. LINTNER. The paper that I submitted to these hearings was based simply upon the work which we have done regarding the effects of corporate taxes on mergers.

Mr. MILLS. Only.

Mr. LINTNER. Only.

I would be glad to supply the committee with a reprint of a summary of other studies which Professor Butters and I have done over the last 10 years, which reach and emphasize the conclusion that a high corporate tax rate does restrict the opportunities for significant growth of small businesses very much more than those of larger well-established companies because of several reasons which have a compounded effect. The restriction on small business is much more severe even though the corporate tax rate is 50 percent for the little fellow and 50 percent for the large fellow. Such a tax not only adversely affects his opportunity to grow from retained earnings, but also places him at an even greater disadvantage than he otherwise would have in getting the outside capital that he often also needs in order to grow.

I will be glad to supply a summary of some of this work if you would like.

Mr. MILLS. I am going to ask permission for that to appear. I think you have it before you there?

Mr. LINTNER. I have.

Mr. MILLS. For that to appear in the record of these hearings at this point. Is there objection?

The Chair hears none.

(The information is as follows:)

EFFECTS OF TAXES ON CONCENTRATION

John Lintner and J. Keith Butters, Harvard University

[INTRODUCTORY NOTE.—This material consists of secs. 1 through 4 and the conclusions of a paper which was originally published in Business Concentration and Price Policy, a roport of the National Bureau of Economic Research (Princeton, Princeton University Press, 1955). Successive sections appraise in general terms the effects of taxes on (1) the formation and early growth of new firms and enterprises, (2) management incentives to growth and expansion, (3) relative rates of growth of different sizes of firms through retained earnings, (4) the availability of outside funds to finance expansion for larger and smaller concerns. A fifth section in the original paper on the effects of taxes on mergers is omitted here since all the points made in that section were included in my paper for these hearings.]

1. FORMATION AND EARLY GROWTH OF NEW FIRMS

The first segment of our analysis deals with the effect of taxes on the formation and early growth of new firms—roughly up to the point at which they become capable of profitable operations. The importance of this phase of business development hardly needs to be stressed. The continued formation of successful new firms is needed to replace existing business units that fall behind or drop out of the competitive race. Even more important, new firms are needed to develop new ideas, techniques, and products that can potentially offer effective competition to established firms. A high birth rate of new firms is required to prevent an increase in concentration, because mortality rates are higher for small firms than for larger enterprises and because the mortality of new firms is high. In particular, any reduction in the rate of formation of new firms would tend to increase the share of total output accounted for by a fixed number of large firms (absolute concentration) and to concentrate the total of all activity among a more limited number of firms.

Taxes may affect the formation and early growth of new firms in two ways. First, they may dull the incentives needed to induce people to undertake to establish new business concerns. Secondly, taxes may impair their ability to do so by restricting the supply of capital required to finance the formation and early growth of new firms. We shall consider these two types of effects separately.

So far as incentive effects are concerned, our conclusion is that tax considerations generally do not play a critical role at this stage of development of a business organization. At least until the enactment of the present excess-profits tax,[1] the effect of taxes on profit prospects appears typically to have been given little conscious consideration by the individuals actually responsible for the organization of new enterprises. We recognize, of course, that new firms will seldom be started at all if their founders do not expect them to be profitable, and with rare exceptions their survival as well as their subsequent growth will depend upon their ability to earn a profit; but the precise amount of this expected profit does not usually have an important bearing upon the decision to undertake the business. When a new business is organized, only the crudest estimates of its profit potentialities can be made, even when the growth potential seems to be great. The impossibility of estimating profits prospects with any degree of precision at this stage of a corporation's development tends to preclude a careful evaluation of the effect of taxes on these indefinite profits prospects—unless tax rates approach confiscatory levels and are expected to remain there.

Another factor diminishing the importance of the incentive effects of taxes in the formative stages of a new business is that the kind of individuals who are interested in organizing new businesses are often motivated to a marked degree by nonpecuniary considerations. They tend to be aggressive, confident of their ability to succeed, anxious to be their own boss, and desirous of developing a new idea in which they are intensely interested. If the organizer's primary interest is in the satisfaction of creating something new and in the power that goes with a successful business development, as it often is, tax considerations tend to be viewed as of only second importance.

While taxes do not generally appear to have an important effect on the desire of individuals to start new enterprises, they may have a pronounced effect on

[1] We have done no empirical work on this topic since Korea.

their ability, i. e., on their financial capacity, to do so. Practically speaking, a minimum amount of ownership capital is essential to the formation of every new business, however small. In the very early stages of a new business, this capital must usually be supplied from the personal resources of the individuals directly interested in the business, or by their immediate relatives and friends; outsiders typically have little interest in new ventures until they have developed to the point where they give real indications of being potentially profitable. Consequently, unless the individuals immediately concerned can accumulate the minimum amount of capital needed to start the enterprise, the chances are that it will never be organized. By making such accumulations more difficult, the tax structure has a significant, though limited, effect on the formation and early development of new enterprises.

After the initial developmental phases of a new enterprise have been completed and the promoters have demonstrated that they have a potentially salable product or service, the feasibility of raising outside capital from disinterested sources is often greatly increased. Generally, also, the stage of getting into production is one at which substantial new financing is required; in most industries, it is a rare new venture that can pull itself up by its own bootstraps and become a stable, revenue-producing enterprise of significant size without having to draw on outside capital in the transition from a developmental to a producing organization. A critical test for many enterprises is their ability to raise additional equity capital at this stage of their growth.

At this stage, as well as in the early formative and developmental stages, the only possible sources of equity capital are those supplied from outside the enterprise. Until the business develops an independent earning power of its own—and frequently for a long period thereafter—it will absorb rather than throw off capital. For an operation of significant size, moreover, the task of getting into production is likely to require larger amounts of financing than can be raised from the immediate resources of the promoter and his associates. At this point in their development, therefore, numerous (perhaps most) expanding companies have to turn to disinterested private investors, acting individually or through an investment organization, for outside capital. To the extent that taxes affect the capacity and willingness of investors to put money in small, growing enterprises at this phase of their growth, therefore, they are likely to have an important effect on the continued existence and rapidity of expansion of such companies. If the needed capital is not forthcoming, the alternatives are likely to be to sell out—often to a larger competitor—or to strive to continue the development with inadequate resources and the almost inevitable consequence of ultimate failure.

The effects of taxes in this respect, however, are mixed and complex, and it is difficult to appraise their net impact. So far as the personal income tax is concerned, the high rates of this tax on individuals with large incomes obviously reduce the capacity of these individuals to accumulate funds for equity investment, and the evidence indicates that the willingness to make such investments is heavily concentrated in the very small fraction of individuals in the economy with large incomes. In this respect, the personal income tax clearly tends to increase the cost of equity capital to growing enterprises by reducing the potential supply of such funds, as compared to a tax structure bearing less heavily on the upper income classes. (It should be noted in passing, however, that the effects of the income tax structure in this regard are not as severely repressive as is often claimed because of the variety of ways in which individuals can accumulate large amounts of new investable funds without being subject to the full impact of the personal income tax rates.)

At the level of investment policy (as contrasted with investment capacity), however, the situation is more complex. To the extent that the tax structure reduces the potential income yield from investments in growing enterprises, the effects of the income tax will further compound the previously noted effects on capacity to invest. To the extent, however, that the motive for investing in small, growing enterprises is to make capital gains—and this is probably the dominant motive—the tax structure has a quite different impact. In this case, the large differential between the upper bracket rates on ordinary income and the favorable rates (not exceeding 26 percent) on long-term capital gains often operates as a positive attraction to investments in growing enterprises.

The strength of this inducement will be particularly strong for venturesome investors who are not averse to taking substantial risks of capital loss, provided that the compensating opportunities for capital appreciation are sufficiently great, and for companies with outstanding growth prospects. The same inducement will be much weaker for more conservative investors who place less of a

premium on capital appreciation in relation to the risk of capital loss, and for companies offering more limited prospects for capital appreciation.

It is hard to say where the overall balance lies, but it is fairly clear that, at the level of investment policy effects, taxes tend to reduce the flow of capital to some types of small companies but to increase it for others. The latter companies—those with outstanding growth prospects—though small in number are of strategic economic importance, since they are the organizations that have the potentiality of challenging the established industrial leaders.[2]

So far as the corporate income tax is concerned, its effects at this stage of a company's growth are obviously limited to its repercussions on the willingness of investors to supply outside capital; the corporate income tax has no effect on internal sources of financing until the company reaches a profitable stage of operations and has exhausted any loss carryovers accumulated during its formative period. Theoretically, the corporate income tax should have a powerful repressive effect on the willingness of outsiders to furnish equity capital to companies in this stage of development. Practically, however, our belief (based, however, on empirical inquiries conducted before the enactment of the current express-profits tax) is that this repressive effect is much less pronounced than has generally been anticipated on theoretical grounds.

The reasons are essentially the same as those explained in the earlier discussion of management incentives. In the early stages of a company's growth, the range of error in estimating its eventual profit potentialities is so great that adjustments for the impact of corporate taxes on these profit potentialties are difficult to make and often are given little attention. As a company reaches more and more advanced stages of development, however, and as it becomes possible to estimate its profit potentialties more precisely, the role of the corporate tax becomes increasingly significant. It goes without saying that the higher the corporate income-tax rate, and the more severe the impact of special corporate taxes (such as the undistributed profits tax in 1936 and 1937 and the current excess-profits tax) on growing enterprises, the more repressive will be the effects of the corporate tax structure on such companies.

In summary, the balance of the above tax effects on new and growing enterprises in the preprofits stage of their development is difficult to strike with assurance, but it seems fairly clear that the overall impact is to penalize this class of company in comparison with the established industrial leaders. (This judgment is hardly subject to question so long as an excess profits tax with high marginal rates is expected to remain in effect.) The tax structure of recent years has tended to reduce the number of new firms organized and carried through the "development of idea" stage, thereby maintaining concentration at a somewhat higher level than it would otherwise have been. Beyond the initial developmental stage, but before the attainment of profitable operations, the tax structure has exerted an influence in the same direction by restricting the capacity of upper bracket individuals to accumulate new investable funds and, to a lesser degree, by the damping effect of the corporate income tax on profit expectations. But against these effects must be set the positive favorable influence of the disparity between the low capital gains rates and the high marginal rates on ordinary income in increasing the willingness of venturesome individuals to invest in highly promising new ventures.

The one statement that can be made wth positive assurance is that no sweeping conclusions apply without exception to all types of firms. The tax factors do not operate all in one direction, nor do they affect all types of firms with equal force. On balance, it would seem that the mixture of stimulating and repressive effects, and the great importance of nontax considerations at early stages in a company's growth, are such that the tax structures of recent years (pre-1950) have not greatly influenced levels of concentration. Insofar as there are tax effects at this stage, however, our judgment is that their net impact has been in the direction of increasing industrial concentration.

2. INCENTIVES FOR EXPANSION

In this and the following two sections, we shall be concerned with the effects of taxes on concentration by way of their effects on the growth of existing companies that have reached the stage of profitable operations. We can, therefore,

[2] For a detailed discussion of the analysis covered in the preceding paragraphs see J. Keith Butters and John Lintner, Effect of Federal Taxes on Growing Enterprises (Harvard Business School, 1945) and J. Keith Butters, Lawrence E. Thompson, and Lynn L. Bollinger, Effects of Taxation: Investments by Individuals (Harvard Business School, 1953).

treat the total number of firms as being constant. Under these conditions it follows that both absolute concentration (the concentration ratio) and relative concentration (inequality) will be unchanged if the relative rates of growth of all firms are identical, and both measures or aspects of concentration will be increased if the effect of taxes is to favor the relative growth rates of larger as compared with smaller firms.

The effect of taxes on incentives for growth for firms of any size depends critically upon the ratio between (a) the size of the new investment undertaking and (b) the minimum reasonably assured income of the company resulting from its established operations over the period within which losses may be offset against income. In cases where the latter exceeds the former, the mean expectation of profits (as a percentage of the initial investment) is reduced in proportion to the tax rate.[3] Moreover, the profits expected if the undertaking is successful, the probable losses if it is unsuccessful, and the net amount of investment at risk are also simply reduced in proportion to the tax.[4] We have found that managements often consider each of these magnitudes, as well as the expected return (summarizing both probable profits and losses together) in appraising new investments. The condition stated above is important because the restrictive effects of the tax on investment incentives will be much less severe when it is satisfied than when it is not.

Most of the individual investment projects of large well-established firms meet the conditions specified. A large number of investment projects considered by small firms will doubtless also fall into this category. Flat rate taxes will damp incentives to undertake these investments no more seriously for the smaller than for the larger firm.

But such investment projects do no more than maintain the orderly growth of a company. Smaller firms frequently have major investment decisions under consideration, which are large in relation to their current size and to any reasonably assured income arising from their current operations.[5] Such major investments are of the greatest social consequence. They are the investment projects that make possible the extraordinarily rapid growth of smaller firms. They are also the undertakings that carry them out of their class and, provided they are successful, enable them to make significant inroads upon the established positions of their larger and stronger competitors. These are consequently the investments that are particularly significant from the point of view of a dynamic competitive structure—i. e., from the standpoint of both industrial concentration and of competitive behavior.

But investment undertakings that are large in relation to the reasonably assured income of the company are precisely the ones for which the incentives are severely impaired by high corporate tax rates. In the first place, where the individual investment project is larger than the reasonably assured income from other operations within the loss-offset period, the mean profit expectancy is reduced more than in proportion to the tax rate. Any profits that may be made if the major new investment proves successful will be taxed in full, but income available from other operations would be inadequate to cover potential losses if the undertaking is unsuccessful.[6]

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[3] It may also be noted that the dispersion of the outcomes contemplated is reduced by the tax, and this should be counted as some positive inducement to invest in the (probably common) cases where corporate management is subject to some risk aversion.

[4] The phrase "in proportion to the tax" used in the text implies a standard of reference in which there was no tax. This choice was made largely as a matter of expositional convenience. The conclusions developed in this paper are equally valid with respect to the differential effects of increases in tax rates, although the factor of proportionality involved is a little more complicated, being not merely the tax rate as in the former case, but rather the ratio of (a) the difference in the two rates to (b) one minus the initial rate.

[5] There are doubtless similar cases involving what would be generally considered to be large firms (in an absolute sense), but in view of the extent of multiplant and multiproduct operations among such firms, the proportion of investments falling in this category for large firms must be small relative to the proportion for smaller firms.

[6] In the event that the new investment involves the commitment of the entire operations of the firm, there will be no income at all available from other sources aganist which losses could be offset if the new development is not successful, and the entire loss would have to be borne by the company; but the profits, if realized, would still be taxed in full. In this event, highly favorable mean expectations of profit before tax can readily become negative—i. e., turn into mean expectations of loss—in the face of high flat-rate corporate taxes.

Even where there is reasonably assured income from the company's existing operations (but this income would not fully cover potential losses on the new investment) expected profits will be reduced much more than in proportion to the increase in the tax rate. In making these estimates, provision must, of course, be made for the effect of the carryback and carryover provisions.

Although the expectation of profit is only one of many motives leading a management to make an investment, most investments will probably not be undertaken without the prospect of some minimum rate of profit in compensation for the risk and effort involved. While an outsider cannot set a numerical value to this rate in each given case, the important fact is that in most cases such a minimum rate exists. Once profits have fallen below this level these ventures will not be undertaken, even though they may be attractive from other points of view. If taxes reduce expected profits below this level in a large number of cases, a substantial volume of employment may be lost.

Moreover, the amount of investment at risk will not, in these cases, be reduced in proportion to the tax rate; indeed, where the source of other income is removed because other operations must be suspended in order to undertake the new development, the amount of new investment at risk will be unaffected by the tax rate. But even this statement unduly minimizes the matter. In situations where the decision to embark on the new undertaking involves serious risk of incurring bankruptcy in the event of failure, the possible loss to the company from major new undertakings would be the entire value of the total investment of the company and not simply the amount specifically invested in the particular project itself. Since the loss to the owners of the company could exceed the amount invested in the new development, the rate of loss computed as a percentage of the new investment could exceed 100 percent. On the other hand, if the company itself has a thin equity position and the expansion was financed mostly with borrowed funds, the actual loss of the owners, in the event of bankruptcy, might be less than the dollar amount invested in the new development.

Finally, to make matters still worse, a high tax would not only lower the net return if the venture were successful, but it would also cut down on the probability of a successful outcome. Major new investment undertakings by smaller firms with limited capital resources are such that any serious hitch in the program may spell complete failure. In major experimental undertakings, it is common experience that there will be many blind alleys and unexpected delays before success is achieved. But each dead-end street adds to the capital that must be committed before the project is completed. High taxes bite deeply into the capital supply of small firms. Since one of the major elements of risk for a small firm is the danger of being caught short of capital and thus of having to abandon a project on the verge of success, high taxes may drastically reduce the prospect of success to a small firm. On the other hand, the large company has much greater leeway for experimentation and mistakes.

In summary, high flat-rate corporate income taxes severely discriminate against major investment expansions (and relatively in favor of minor expansions) because they reduce their probability of success and because they reduce the expected returns on these investments much more severely. The higher the tax, the more severe is the discrimination in each of these respects. Given the greater relative frequency of major expansions in the investment plans of smaller firms, it follows further that high flat-rate corporate income taxes discriminate with special severity against the growth of smaller independent firms and relatively, at least, in favor of larger, established companies. Consequently, the effect of high corporate income taxes on concentration by way of their effect on incentives for growth is to preserve prevailing degrees of concentration and over time to result in higher levels of concentration than would otherwise have existed. In this connection the effect of a progressive corporate income tax or of an excess profits tax would be much more pronounced than that of a flat-rate income tax.

One final point, however, needs to be emphasized in appraising the severity and seriousness of this thrust of the corporate income tax toward greater concentration. The desire of an aggressive business management to expand may be so intense that expansions will be undertaken in spite of the repressive effect of high taxes. Many such managements may be imbued with the spirit to go through with their plans, "come hell or high water." High taxes may cause such men to fail; they are unlikely to prevent them from trying. But quite obviously, although this consideration modifies the extent of the repressive effect of the tax, it does not compromise the fact that the effect of the tax is more severe on smaller firms and that the tax tends to some degree to increase concentration.

The personal tax structure may, in some cases, significantly modify the effects of corporate taxes on management decisions to expand. The net effect of personal tax factors will depend on the particulars of a given case. Our analysis of the complex interactions involved may be found elsewhere.[7] In general, we

[7] Cf. Butters and Lintner, op. cit., pp. 36–39.

conclude that, except possibly for wealthy individuals with widely diversified investments, it does not seem probable that the possibility of obtaining limited loss offsets against personal income taxes will ease the burden of the corporate tax to any appreciable degree. In cases in which the owners have invested a large percentage of their personal assets in a single business endeavor, the personal tax structure probably accentuates the repressive effect of the corporate tax.

If a business is organized as a proprietorship or partnership, the personal income tax greatly reduces the incentive of its owners to undertake major expansions—perhaps more so than the corporate tax impedes expansions by small corporations. The highly progressive rates of the personal income tax strike with full force at the profits resulting from a partnership expansion. But if the expansion is unsuccessful and results in business failure, the partners' personal assets as well as their business assets and perhaps also their jobs will be in jeopardy. Moreover, because of the progressive nature of the personal income tax, the more successful the venture, the larger would be the Government's share in the profits. But the risk of loss remains, and even in the relatively favorable case where other income is available against which partnership losses could be offset, the deduction of losses from this income would result in tax savings in lower surtax brackets, whereas additional income from the partnership would throw the taxpayer into higher surtax brackets. Moreover, under these circumstances the individual partner to some degree would be risking his entire personal assets for a relatively small potential income from the partnership; this income would be taxable at high surtax rates. All in all, under most circumstances the partnership form of organization does not appear very attractive for small enterprises with a large potential growth, even in comparison with the present high taxation of corporate profits.[8]

3. ABILITY TO FINANCE GROWTH FROM RETAINED EARNINGS

The second way in which taxes can affect relative rates of growth of larger and smaller firms is through their effect on the ability to finance expansion by retained earnings. In actual practice, this is likely to be even more important than the effect of taxes on investment incentives. Managements can and often do ignore adverse incentive effects resulting from high taxes, but they cannot safely ignore any substantial impairment of necessary supplies of capital to finance expansion. A company that does not have and cannot get the funds to finance an investment program is effectively stopped, however optimistic its appraisal of profit prospects.

Retained earnings have long been a major source of funds for financing growth of American industrial corporations. This is clearly shown in the history of individual companies and industries, including many of our most rapidly growing smaller firms as well as many of our leading large corporations. Terborgh's data[9] for all nonfinancial corporations show that retained earnings amounted to over 75 percent of the aggregate net expansion in physical assets (including inventory) during the years 1925–29 inclusive, and over 60 percent of such expansion in 1939–41.[10] Corresponding estimates of the Department of Commerce show that the retained earnings of all nonfinancial corporations in the 4 years 1947–50 amounted to about 80 percent of the net increase in plant, equipment, and inventory in these recent years of extraordinary expansion.[11] Similarly, Dobrovolsky's recent tabulations of the National Bureau's samples of large and of small and medium-sized manufacturing corporation shows that.

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[8] In this connection it is pertinent to note that one method of tax relief frequently proposed for small businesses is to allow them to compute their tax liabilities on a partnership basis, although they are organized as corporations. This privilege may be of considerable value to the owners of a corner grocery store or of a local service station. But, unless personal tax rates on incomes of, say, $10,000 and over are reduced much more than now appears feasible it would ordinarily be of little value to small companies with prospects for large-scale growth.

[9] Data from worksheets for the Bogey of Economic Maturity (Machinery and Allied Products Institute, 1945), chart 14, p. 145, kindly supplied to us by the author and used with permission. Retained earnings have been adjusted upward to allow for profits disclosed by audit less resulting additional taxes. If both depletion and "inventory profits" are included in retained earnings, and outlays are correspondingly adjusted, the ratio is 79.5 percent; if both are excluded, the ratio is 79 percent; if the inventory valuation adjustment is made but depletion included, the ratio is over 81 percent.

[10] If both inventory profits and depletion are excluded from both numerator and denominator, the ratio is 61.2 percent; if both are included, 67.5 percent.

[11] Data from Economic Report of the President, January 1952, pp. 203, 172. Without inventory valuation adjustments, the ratio is 83.8 percent; after these adjustments, 79.8 percent. Depletion is included in both cases.

for both size groups of firms, retained earnings substantially exceeded net physical asset expansion not only in the late 1920's but again in the years 1939–43.[12]

The great and continuing importance of retained earnings in financing business growth strongly suggests that the effects of taxes on concentration may be more important through this channel than through any other. In this connection, it should also be noted that retained earnings have been far larger than all the assets involved in corporate mergers, which frequently have been said to be a major determinant of concentration even in recent years. The total amount of assets involved in all mergers in manufacturing and mining during the 8 years 1940–47 was on the order of $5 billion; assuming that mergers have continued at the peak rates of 1945 and 1946,[13] the total would be raised to perhaps $8 billion by the end of 1951—a sum over a 12-year period just about equal to the earnings retained by manufacturing corporations in the single year 1948, and only a modest fraction of the total retained during the full 12-year period.

What then is the distribution of retained earnings by size of firm? And what has been the effect of taxes on this distribution? Since our main concern is with the effect of income taxes, and unprofitable firms pay no income taxes, we shall confine our analysis to the retained earnings of profitable corporations. Moreover, in order to deal specifically with the sector in which the issue of concentration is most important,[14] our statistical analysis will be confined to manufacturing industries.

Analysis of data in Statistics of Income shows the following relationships:

1. As would be expected, the distribution of retained earnings among profitable manufacturing corporations is highly concentrated. In 1947 and 1948, for instance, only 0.4 percent of all profitable manufacturing corporations had assets of more than $50 million, but these companies had 30.6 percent and 42.1 percent of all earnings retained in the 2 years. At the other end of the scale, the 96.7 percent of companies with assets under $5 million accounted for only 38.9 percent and 29.7 percent of the retained earnings of profitable manufacturing in the 2 years.

2. Even so, retained earnings were less concentrated than were total assets, net worth, profits, or even sales. Illustrative data for 1947 and 1948 are given in table 1.

TABLE 1.—*Percentage of various totals for all profitable manufacturing corporations held by companies with assets over $50 million and $100 million, 1947 and 1948*

	Companies with assets over $50 million		Companies with assets over $100 million	
	1947	1948	1947	1948
Retained earnings	30.6	42.1	23.1	34.5
Net worth	50.2	52.5	42.5	44.2
Total assets	49.8	52.7	42.1	44.4
Profits before taxes	38.7	47.8	30.9	39.3
Profits after taxes	39.0	48.1	31.2	39.7
Gross business receipts	40.2	42.6	32.7	35.7
Number of corporations	.4	.4	.2	.2

Source: Statistics of Income, Department of the Treasury, pt. II; data supplied in correspondence.

3. This conclusion is strikingly confirmed by table 2, which shows that in every year from 1931 through 1948 (the last year for which data are available) the average retained earnings of profitable smaller manufacturing companies consistently constituted a much larger percentage of their net worth,[15] than

[12] Sergei P. Dobrovolsky, Corporate Income Retention, 1915–43 (National Bureau of Economic Research, 1952), pp. 74 and 79.

[13] Our tabulations indicate that assets acquired in mergers were greatest in these 2 years, averaging about $750 million. For sources, cf. J. K. Butters, J. Lintner, and W. L. Cary, Effects of Taxation on Corporate Mergers (Harvard Business School, 1951), ch. IX.

[14] Cf. Adelman, op. cit., pp. 286, 287.

[15] Incidentally, they also quite consistently constituted a larger percentage of their total assets.

did the retained earnings of larger companies.[16] In 12 of the 18 individual years the ratios of retained earnings to net worth decline from size class to size class with no exceptions; in the remaining years, the irregularities were minor.[17]

TABLE 2.—*Retained earnings as a percentage of net worth, all manufacturing corporations with net income, 1931–48*

[Asset size classes in thousands of dollars]

Year	Total	Under $50	$50 to $100	$100 to $250	$250 to $500	$500 to $1,000	$1,000 to $5,000	$5,000 to $10,000	$10,000 to $50,000	$50,000 to $100,000	$100,000 and over	$50,000 and over
1931	0.2	7.3	4.5	2.9	2.3	1.7	1.6	0.7	0.1	---------	---------	[1] 1.0
1932	[1] .3	4.1	2.9	2.8	2.0	1.7	1.1	.6	0	---------	---------	[1] 1.4
1933	1.7	5.7	5.8	5.7	5.6	5.3	4.0	3.8	1.8	---------	---------	[1] .2
1934	2.0	5.1	5.4	5.7	4.9	3.7	2.1	3.0	.9	---------	---------	1.4
1935	2.9	6.8	6.0	5.6	5.1	4.5	3.6	2.3	1.6	---------	---------	2.5
1936	1.6	5.4	3.6	3.4	3.1	3.5	3.3	2.9	1.9	1.4	[1] 0.3	0
1937	1.6	4.7	3.7	3.1	2.9	3.1	2.8	2.4	1.5	.6	.8	.8
1938	1.7	6.9	6.3	5.1	4.1	3.5	2.6	2.0	1.3	.9	.7	.8
1939	3.1	8.7	7.9	6.9	5.9	5.3	4.5	3.9	3.2	2.2	1.5	1.6
1940	4.1	9.6	8.2	7.5	6.6	6.5	5.8	4.7	4.0	4.2	2.5	2.8
1941	5.9	14.4	12.2	11.2	10.1	9.8	8.4	7.3	5.7	5.7	3.5	3.9
1942	5.7	15.3	11.7	10.2	9.2	9.0	8.4	7.8	7.0	5.6	2.8	3.2
1943	5.9	16.8	11.7	9.9	8.8	8.6	8.3	7.7	7.0	6.2	3.8	4.1
1944	4.5	19.5	13.0	10.4	8.5	7.8	7.4	6.4	5.2	4.6	2.0	2.3
1945	2.8	18.3	13.1	9.8	8.0	7.2	5.9	4.3	3.4	2.5	[1] .1	.2
1946	7.5	22.5	20.4	18.4	17.4	17.2	14.5	10.8	8.2	5.9	1.3	2.0
1947	9.5	18.0	16.7	15.5	15.2	15.5	15.1	12.7	10.5	9.2	5.1	5.8
1948	9.2	16.0	14.1	12.7	12.2	12.2	11.9	11.1	10.0	8.4	7.2	7.4

[1] Negative retained earnings resulting from an excess of dividends over net profit after taxes.

Source: Computed from Statistics of Income, Department of the Treasury; 1947 and 1948 supplied by correspondence.

The persistency of the relationships found between ratios for different sized groups in every one of the 18 years strongly suggests that these relationships represent continuing characteristics of profitable firms.[18] Moreover, firms with ability to grow are likely to be the more consistently profitable firms over a period of years because they are likely to be the ones with the better products and managements. These firms are also likely to be even more profitable and retain an even higher percentage of those profits than profitable small firms in general, and a fortiori higher than profitable larger firms.

Thus there can be little doubt that consistently profitable smaller firms have been able to finance a more rapid rate of growth from retained earnings than larger profitable companies. The importance of this fact with respect to corporate concentration is obvious: retained earnings among profitable manufacturing corporations have been a potent factor tending to deconcentrate the manu-

[16] The purely statistical significance of the relationship may be judged by the rank-X^2 test with 8 degrees of freedom (cf. Milton Friedman, The Use of Ranks to Avoid the Assumption of Normality Implicit in the Analysis of Variance, Journal of American Statistical Association, December 1937, pp. 675 ff.). Fisher's tables show that there is only one chance in 100 that observations drawn at random from a parent universe in which the true mean rate of retained earnings was the same in all size classes would yield an X^2 as great as 20.09. Since the observations in table 2 give an X^2 based on this null hypothesis of 140.31, the conclusion that retention rates are related to size of firm is clearly indicated.

Corresponding tests of the hypothesis that the observed data were drawn from a universe in which the ratios progressively declined without exception from size group to size group show it to be quite "consistent" with the data.

[17] It may also be noted that the average of the ratios for the prewar years 1931–40, and also those for 1941–48, declines from size class to size class without exception.

[18] In our judgment, the persistence of these relationships, together with the considerations brought out in the rest of this paragraph, persuasively establish the broad conclusions reached despite any technical qualifications that might be thought necessary due to the changes in the makeup of the profitable group of firms from year to year. Such shifts would, of course, be due to the fact that the firms in any size group that are profitable in one year may not have been so in others. Other shifts, of lesser potential significance to our conclusions, will occur as some firms move from one size group to another because of profits or losses, changes in outside liabilities, or capital accounts.

It should also be noted that the ambiguity of data for small companies (taken up later) does not affect the validity of the ratios of retained earnings to net worth, since any understatement of "true" profits implies an equal and offsetting understatement of "true" withdrawals via dividends.

facturing sector of the economy.[19] But the degree of its importance can appropriately be emphasized. Such differences in rates of growth are cumulative, and the differences in growth over a period of years—and hence the amount of deconcentration affected—will be substantially greater than the rates of retained earnings on net worth by themselves would suggest.[20]

Such considerations, along with the extraordinary consistency of the decline in the retained earnings to net worth ratio with increasing size of firm, leave little doubt that here is one of the major factors tending positively to reduce prevailing levels of concentration.

This conclusion is further emphasized by the evidence that retained earnings are a much more important source of funds to finance expansion for smaller than for larger concerns. Not only are retained earnings larger in relation to net worth and assets for profitable small corporations,[21] but smaller companies generally have much less access to outside capital than larger companies. Generally speaking, small companies can expect to be able to float stock only in limited periods of booming markets and even then often only on relatively unfavorable terms. In contrast, large, established concerns, in addition to their ability to float common stock with much greater ease than smaller companies, can often sell preferred stocks or bonds. These alternatives are available to smaller concerns only on a limited scale, on considerably more expensive terms, and at great risk to the common stockholder.

Finally, even when available, outside capital is likely to be less acceptable to smaller firms than to larger. This reaction is attributable to the generally more onerous terms already mentioned and also to the fact that the owner-managers of small firms are frequently unwilling to weaken their control position and freedom of action by acquiring equity capital. Such control-conscious managements are sometimes unwilling to incur the risks and restrictions involved in issuing senior equity and debt securities or in other forms of borrowing. The importance attached to control considerations depends both on management attitudes and objectives and upon such factors as how widely the company's stock is distributed.

The fact that retained earnings are a more critical source of funds for financing expansion for smaller than for larger companies leads to a further conclusion of major consequence to our analysis: High corporate income taxes will restrict the growth of smaller firms more severely than that of larger companies—and thereby tend to increase concentration—even if their relative impact on growth from retained earnings alone were the same for all sizes of firms. Because of the greater importance of retained earnings to smaller firms, an unshifted corporate income tax could have a neutral or favorable effect on concentration only if it were found to restrict the internally financed growth of large firms much more severely than that of smaller companies.

What, then, has been the effect of taxes on the relative ability of larger and smaller firms to grow through retained earnings? Analytically, it can be shown that higher as compared with lower corporate income tax rates will restrict potential internally financed growth more than in proportion to the differences in the rates.[22] Moreover, this restriction is cumulative in character and will be more severe (*a*) the longer the tax is in effect, (*b*) the higher the initial rate

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[19] It is necessary to emphasize that this conclusion relates simply to the effects of retained earnings of profitable firms; specifically, it does not extend to the effects of all retained earnings (positive and negative) of all firms, whether profitable or not, on concentration. Unpublished data show that the negative retained earnings of unprofitable firms have consistently been much larger in relation to net worth and total assets for small than for large firms; their effect has therefore been to increase concentration. But this is not relevant to the present paper since, as emphasized earlier in the text, we are concerned with the effects of (income) taxes on concentration; only profitable firms pay taxes; therefore taxes affect concentration through retained earnings only insofar as they affect the retained earnings of profitable firms.

[20] As a specific illustration, the retained earnings to net worth ratio in 1947 for companies with assets between $1 million and $5 million was 15.1 percent—or not quite 3 times the 5.1 percent ratio for firms over $100 million. But, if these ratios were maintained for as little as 10 years, net worth of the smaller firms would have increased 308 percent—or nearly 5 times the 64 percent increase of the largest size group of companies. Similar calculations using the (still higher) retained earnings ratios of smaller size groups of firms would show even greater contrasts. While no particular significance is attached to these specific figures, they do serve to illustrate the important cumulative effects involved.

[21] They are also markedly and regularly larger in relation to total internal sources of funds for investment, which include such noncash expenses as depreciation and depletion allowances and other accruals as well as retained earnings, than for larger firms.

[22] Detailed proofs of these propositions, as well as illustrations of their impact and detailed studies of individual companies having outstanding growth records, have all been given in Butters and Lintner, op. cit., ch. VI, and John Lintner, Tax Restrictions on Financing Business Expansion (Ph. D. dissertation, Harvard, 1946), ch. III and appendix B.

of the tax, (*c*) the higher the rate of profit earned by the company, and (*d*) the more conservative the dividend policy of the company in question before the tax increase. Consequently, a high flat-rate corporate-income tax—or an increase in the rates of this tax—will restrict the growth of smaller firms more than that of larger firms, and thus serve to increase concentration, if two conditions are fulfilled: (1) the smaller firms are earning a higher rate of profit before tax than the larger firms and (2) the smaller firms are paying out a smaller proportion of their net income as dividends than large concerns.

For companies with assets of over $1 million, the statistical evidence regarding the effect of the tax laws since 1931 on concentration is unequivocal: in every year their effect was consistently and markedly to increase concentration within this size range. The significance of this finding is indicated by the fact that this size range in 1948 included about 10,000 manufacturing concerns.[23] Given the size of the economy and the character of most of our more important industries, it is clear that the absolute and relative size of the firms in these size classes are matters of major consequence for all those aspects of concentration most closely related to competitive practices and performance.

The evidence in question may be summarized as follows: (1) Within these size classes smaller profitable firms quite consistently enjoyed markedly higher rates of profit before taxes on net worth than larger sized firms.[24] In 1946–48, for instance, profitable companies with assets of from $1 million to $5 million averaged virtually 30 percent on net worth before taxes, while companies over $100 million averaged about 16 percent, and the decline from size class to size class was quite regular and marked in virtually all of the 18 years analyzed. (2) Effective tax rates on smaller firms in this size range were quite consistently as high and generally higher than for the larger firms. (3) With even greater regularity throughout this 18-year period, smaller firms retained a larger proportion of their disposable income than did larger concerns.

For instance, in the 10 years 1931–40, profitable firms with assets of between $1 million and $5 million retained an average of 27.6 percent of their profits after taxes while firms with assets over $5 million retained 7.86 percent. In the postwar years 1946–48 the smaller firms retained 74.3 percent, while the larger group retained less than 50 percent. The share retained declines between every pair of size classes over $1 million in every one of the 10 years 1939 through 1948 and, as shown in table 3, aberrations in earlier years are few and minor.[25] This relationship is also found with similar consistency in a marked degree on a marginal as well as an average basis.[26]

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[23] In this year there were 9,228 companies showing net profits and 936 with deficits or 10,164 for the total number of companies submitting balance sheets and having assets over $1 million.

[24] The available evidence indicates that this same pattern is found in the separate major divisions and individual industries within manufacturing as a whole. See W. L. Crum, Corporate Size and Earning Power (Harvard University Press, 1939). Spot checking for later years also confirms the relationship.

[25] For the 18 years 1931–48, with firms over $50 million combined in one class, the table yields an Xr^2 of 48.33, in comparison with a value of 11.34 based on the null hypothesis (1 percent level using 3 degrees of freedom) and a maximum value of 54.00 obtainable from such a table in the event of perfect consistency. Beginning with 1936 it is possible to separate the firms with over $100 million in assets. The 13 years 1936–48, with 5 columns and 4 degrees of freedom, the maximum value of Xr^2 assuring perfect consistency would be 52.00, the table yields a Xr^2 of 50.648, and the "1 percent level" is 13.28.

[26] This statement is based upon regressions, for each size group separately, of dividends against profits after taxes for the years 1934–41 (except 1936–37) and also for 1942–48.

TABLE 3.—*Retained earnings as a percentage of net profits after taxes, all manufacturing corporations with net income, 1931–48*

[Asset size classes in thousands of dollars]

Year	Total	Under $50	$50 to $100	$100 to $250	$250 to $500	$500 to $1,000	$1,000 to $5,000	$5,000 to $10,000	$10,000 to $50,000	$50,000 to $100,000	$100,000 and over	$50,000 or more
1931	2.6	63.4	51.4	36.8	29.7	21.2	21.1	7.6	1.7	[1] 12.0	----------	[1] 12.0
1932	[1] 4.8	44.0	40.5	39.4	29.0	24.0	16.9	7.7	.2	[1] 26.9	----------	[1] 26.9
1933	28.4	65.4	74.7	69.0	67.8	62.3	52.9	45.8	24.2	[1] 4.6	----------	[1] 4.6
1934	24.9	46.2	57.9	60.7	51.0	38.9	24.3	33.1	11.7	18.1	----------	18.1
1935	29.4	62.0	60.1	54.5	49.1	41.7	35.9	22.9	15.8	27.3	----------	27.3
1936	16.0	42.0	30.6	28.4	26.1	29.4	29.0	25.7	19.0	13.4	[1] 3.7	.1
1937	17.0	35.8	32.1	27.1	25.8	27.4	25.8	23.4	15.6	6.9	9.8	9.3
1938	23.7	58.4	61.3	51.7	45.9	40.0	32.5	26.9	19.1	12.0	12.1	12.1
1939	35.1	68.7	67.1	60.7	52.8	49.4	42.9	39.3	34.9	26.6	21.4	22.5
1940	41.7	72.5	66.9	62.3	56.7	55.3	50.7	44.4	40.8	37.1	30.5	32.1
1941	50.0	80.0	77.5	73.5	68.5	65.6	59.5	55.8	49.0	43.8	36.3	38.0
1942	55.2	84.2	81.3	76.1	70.8	69.4	66.1	62.7	59.7	52.4	37.1	40.2
1943	57.9	83.9	79.0	73.9	70.2	69.4	66.8	63.8	59.5	54.8	47.2	48.6
1944	49.6	86.5	79.6	76.5	71.8	66.8	65.8	59.9	52.7	49.1	28.4	32.2
1945	38.1	87.8	84.0	77.7	72.6	67.6	60.8	49.4	42.4	32.6	[1] 2.4	4.7
1946	58.9	86.1	86.5	83.8	80.0	79.4	75.7	66.4	59.1	50.5	19.7	27.0
1947	62.9	85.8	84.0	81.9	79.9	77.3	75.4	68.7	63.7	60.4	46.5	49.2
1948	61.8	85.3	84.3	80.3	76.6	74.6	71.3	66.8	63.2	56.2	53.7	54.1

[1] Negative retained earnings resulting from an excess of dividends over net profit after taxes.

Source: Computed from Statistics of Income, Department of the Treasury; 1947 and 1948 supplied by correspondence.

The extent to which the tax structure encourages concentration among firms with assets of more than $1 million may be roughly indicated in the following way. During the 8 years 1941–48 the average rate of retained earnings on net worth of companies in the $1 million to $5 million group was 10 percent; for companies over $100 million, 3.2 percent. If there had been no tax, and if the companies would have retained the same percentage of the funds that were paid in taxes as they retained from their actual disposable income,[27] these rates of retained earnings would have been raised to 20.6 percent and 5.9 percent respectively. By using their average actual retained earnings rates, we may compute that average companies in the $1 million to $5 million bracket would have grown over a 10-year period by 159.3 percent of their initial size, if they were to have been continuously profitable. Using the computed rates under an assumption of no taxes, the corresponding 10-year growth would have been 550.9 percent. The restriction in growth due to taxes for these smaller firms may, therefore, be taken as 390 percent of their initial size. On the basis of the same set of assumptions,[28] for companies over $100 million, the restriction in growth due to taxes would have been only 40 percent of their initial size. Under these assumptions, taxes may be estimated to have deprived smaller firms of realtively about 10 times as much growth as larger firms.[29] These estimates, of course, need to be adjusted downward to allow for such factors as the greater variability of earnings rates among smaller firms, but even in their present rough form they are sufficient to indicate that this effect of the tax structure probably is of major consequence.

The statistical evidence regarding the effect of taxes on concentration is considerably less clear for firms with assets of less than $1 million. In the first place, while the rate of profit earned before taxes by profitable firms generally declined with increasing size up to $1 million before the war, the wartime pattern was mixed; in the 3 postwar years for which data are available, average

[27] These percentages were 67.7 percent and 33.3 percent respectively.

[28] In addition to the assumptions already stated, this entire set of illustrated calculations assumes that the corporate income tax is unshifted, that the demand for the companies' products and the percentage rate of net income before taxes would not be affected by the level of the tax, and that new issues and retirements of stock would be made in the same dollar amounts. For discussion of the reasonableness of these assumptions, cf. Butters and Lintner, op. cit., pp. 87–88.

[29] If instead of using average propensity to retain earnings, we use the marginal propensities based on regressions for the years 1941–48, then the computed (average) retained earnings ratios in the absence of taxes become 23.5 percent and 8.4 percent respectively. Over 10 years the smaller companies' growth would have been 725.2 percent of their initial size and the larger companies' growth would have been 124 percent. Larger companies on this basis lost a growth of 87 percent of their beginning size as a result of taxes while smaller companies lost 566 percent or relatively 7 times as much.

reported rate of profit tended to increase modestly with size of firm within this range. Since, however, reported profits generally tend to be substantially below "true" profits among firms with assets of less than $1 million,[30] the significance of these "reported" relationships is, to say the least, ambiguous.

Second, due to exemption features and to preferential tax rates for small companies, the average effective rate of tax on reported profits generally tended to increase with size of firm up to about the $1 million asset level, with the progression being especially marked after 1940. This apparent progression of effective tax rates with increasing size of firm would be even more marked if tax liabilities were related to "true" profits earned by firms in these size classes. On the other hand, the share of reported profits after taxes paid out in dividends consistently and markedly increased with increasing size of firm throughout the period,[31] but the pattern that would be formed by the economically relevant magnitudes is in doubt.

Such considerations would suggest that, because of the favorable tax treatment accorded smaller firms, the tax structure on balance has restricted the growth of small firms somewhat less than that of larger firms within the $1 million and under asset size class; its net effect within this size class may have been to facilitate some small deconcentration of the corporate structure. Before this conclusion is accepted as final, however, appropriate allowance must be made for the fact that the more vigorous and progressive companies will have higher rates of profit (and presumably more conservative dividend policies) than the average profitable company in their size group. Such firms probably were subject to effective and marginal tax rates that were as high as those on larger firms, since the tax concessions accorded smaller firms were based upon the dollar amount of profit. The impact of the tax structure on such companies, therefore, has tended to increase concentration even in the size groups having assets of less than $1 million.[32]

In the absence of further data and much more exhaustive analysis, it is not possible to strike a definite and firm balance between these considerations. But insofar as our concern with concentration is focused upon those aspects of competitive structure most closely related to probable market behavior, the subgroups of small firms noted are disproportionately important because these companies have the best chance of offering an effective challenge to large, well-established concerns. There is consequently a real possibility that the tax structure has been no more than neutral and may even have tended to increase effective concentration among firms having assets of less than $1 million. This probability is of course much increased when the impact of the existing excess profits tax is taken into account.

When our conclusions regarding the effects of taxes on concentration among firms having more than $1 million in assets and among those of smaller size are combined, it seems clear that the tax structure on balance tended to increase concentration insofar as its impact upon opportunities for internally financed growth are concerned. This conclusion seems clear whether one looks to the decade of the 1930's, to the war years, or even to the early postwar years. In view of the effect of relative rates of growth of profitable firms on concentration and the critical importance of retained earnings in financing such growth, this conclusion is of major significance to our analysis.

Restrictions placed by high corporate taxes on expansion from retained earnings may be offset in part by increased reliance on outside financing. To the extent that this occurs, the restrictions due to the tax on the total amount of investment and growth in the economy are reduced, but the effects on concentration are worsened. As previously noted and as discussed in detail below, outside capital is generally available on less restrictive terms to large firms than to small. Moreover, managements of large companies typically are less

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[30] See Joseph L. McConnell, Corporate Earnings by Size of Firm, Survey of Current Business, Department of Commerce, May 1945, pp. 6–12, and Sidney Alexander, The Effect of Size of Manufacturing Corporation on the Distribution of the Rate of Return, Review of Economics and Statistics, August 1949, pp. 229–235.

Both McConnell and Alexander find on the basis of independent tests that the understatement diminishes progressively with increasing size of firm; McConnell finds it "insignificant" for groups of firms having assets over $1 million (op. cit., p. 8) and Alexander also finds it to be quite small in the $1 to $5 million and larger groups.

[31] For what it is worth, we may note that this relationship was as marked and regular in the under $1 million size classes here being considered as it was among firms having assets over $1 million.

[32] As previously explained, the same rate of tax will penalize the growth of such very profitable firms more severely than that of larger, less profitable companies.

reluctant to resort to outside financing than are managements of small companies. In terms of the effects of taxes on concentration, therefore, we may conclude not only that the internally financed growth of large corporations is restricted relatively much less than that of smaller companies by income taxes, but also that for the larger companies relatively more of this restriction is "made up" through outside financing than is the case for smaller companies. For both reasons, corporate income taxes have markedly tended to increase concentration.

4. AVAILABILITY OF OUTSIDE CAPITAL

In addition to their differential effects on incentives to expand and upon ability to finance expansion from internal sources, taxes can affect relative rates of growth of larger and smaller firms—and thereby concentration—by altering the availability of outside capital needed to finance growth. The effects of taxes on the availability of outside capital arise largely from considerations developed in previous sections.

Our consideration of the effects of corporate taxes on the availability of outside capital can best be focused on the more promising smaller concerns. The problem is of less practical importance for other smaller concerns because of their limited access to outside capital in any event, and the effect will be similar, though less marked.

It has been shown that a high corporate tax would sharply lower the profit expectancy of a risky expansion undertaken by a small company, and in addition, would greatly reduce the potential expansion from retained earnings of a growing company over a period of years. But the principal attraction offered by the stock of small companies undertaking venturesome developments is the prospect of high profits and rapid growth. A high corporate tax, by limiting these prospects, would almost inevitably hold down the value of the stock of such companies.[33]

The practical effect of lower stock prices would be to make expansions financed by outside capital much less attractive to existing stockholders. These stockholders would be required to surrender an increased percentage of their ownership interest in their company as a price for a given amount of new capital. If the existing management or stockholders insisted on maintaining a specified percentage ownership in order to protect their control position, the deterioration in the terms on which outside capital could be obtained would reduce, often substantially, the amount of new capital which could be raised. This reduction in the available outside capital would increase the chances of failure in the whole investment undertaking.[34]

In this respect a high corporate tax would seriously worsen the position of a growing firm in competition with its more stable established competitors. The point may be illustrated by considering the relative effects of, say, a 25-percent and a 50-percent corporate tax rate on a vigorous, small, growing enterprise (company S), and on a well-established, large competitor (company L), which, it is assumed, has reached its full growth and is expected to operate at a relatively constant volume and level of profitability for some years to come. Since the larger competitor's net income is not needed to finance expansion, it is paid out in dividends to stockholders. For purposes of discussion, assume also that the full burden of the tax is borne by stockholders and that the stock of company L would sell at the same multiple of its annual earnings after taxes, irrespective of the level of the tax rate. Under these circumstances a higher tax rate would reduce the price of the stock of company L approximately in proportion to the decline in its income resulting from the higher tax. A 50-percent

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[33] Stock prices in general will not necessarily decline in proportion to the decline in (expected) net income resulting from an increased tax. Conceivably, the capital seeking the higher return available on equity investments may be sufficiently large and determined to cause the stock market to find its equilibrium at a higher price-earnings ratio with a high corporate tax than with a lower corporate tax. Even admitting this possibility, however, it is highly probable that a high corporate tax would result in a lower level of stock prices in general than would a lower tax. If this probability holds for stock prices in general, it may be regarded as a virtual certainty for highly speculative stocks in which the risk of complete loss is great.

[34] See above.

tax rate, for instance, would result in a 33⅓-percent lower price on the stock of company L than would a 25-percent tax rate.[35]

Under the same circumstances, however, a 50-percent tax, as compared with a 25-percent tax, would cause a much greater relative deterioration in the price of company S's stock. The market valuation of its stock is presumably determined by offsetting the discounted value of the potential earning power of the company against the risks faced by the company—risks which are obviously much greater for company S than for its established competitors. As already noted, the cumulative effect of a higher tax on such a growing company would reduce its future earning power much more than in proportion to the decline in income resulting from the tax in any given year. In addition, the higher tax would increase the risks of such a venture. For instance, the very survival of a growing company in a competitive industry, let alone its expansion, depends in large measure on its ability constantly to improve its products and to increase the efficiency of its operations. To the extent that taxes cut into the company's limited capital supply, the necessary improvements will be more difficult to introduce.

It should be noted in passing that, in addition to cutting down the retained earnings of company S and making outside capital less accessible, a high corporate tax would indirectly decrease the borrowing power of the company. The ability of a company to borrow depends largely on the strength of its net worth and working capital positions. Increased tax payments would obviously weaken both of these positions. The resulting reduction in borrowing power would constitute a much more serious limitation on a small, growing company than on a large, established company.

To summarize, in addition to curtailing drastically the potential earnings power of company S in future years, a high corporate tax would increase the risks confronting the company. Such a tax, on the other hand, might even make the future of company L more secure. It would lessen the intensity of the competition that established companies would face from small but rapidly growing competitors. The combined effect of all these considerations makes it appear almost certain that a high tax rate would depress the price of company S's stock and its ability to borrow much more than that of its well-established competitors.[36]

The importance of this fact is still further accentuated when the relative need of the two companies for outside capital is compared. Even with a very high tax rate, an older, established company often would have large amounts of funds available from its noncash expenses. Indeed, the level of corporate taxes might have little effect on the actual operations of a company that had reached its full growth; higher taxes might simply mean lower dividends for stockholders.

Vigorously growing small companies, on the other hand, typically cannot rely to an equivalent degree on funds becoming available in the form of depreciation and other reserves. They must depend primarily on retained earnings and outside capital for funds with which to purchase new assets and to finance the introduction of new processes and techniques.

The general conclusion indicated by all these considerations is that after a new business has reached the stage of profitable operations, high corporate taxes exert a strongly repressive effect on expansion financed either by retained earnings or by the acquisition of outside capital, and thereby serve to increase concentration.

The effects of the personal tax structure upon the availability of outside capital to business enterprises is analytically similar to the discussion already presented in section 1 and need not be repeated in full at this point. It should however, be noted that investor motivations for the purchase of the stock of large established companies may differ substantially from those for investments in small, growing companies. In particular, the desire to obtain a good income

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[35] Suppose that company L earns $4 million a year before taxes, that it has 4 million shares of capital stock outstanding, and that its stock sells at 10 times its annual earnings. With a corporate tax rate of 25 percent, net income after taxes would be $3 million and the price of the stock would be $7.50 a share. With a corporate tax rate of 50 percent net income after taxes would be $2 million and the price of the capital stock would be $5 a share, 33⅓ less than with a 25-percent tax.

[36] This comparison, for purposes of simplicity of presentation, has assumed that a corporate tax is not shifted to consumers or wage earners and that the price-earnings ratio of the stock of company L would be unaffected by the level of the corporate tax rate. Neither of these rigid assumptions, however, is essential to the logic of the argument. So long as company S and company L are equally affected, the conclusions of the text hold.

yield is likely to be a much more important consideration in the purchase of the stock of a large, established company than that of a small, growing company. On the other hand, the capital-gains motivation is relatively more important as a reason for the purchase of unseasoned stocks issued by small, growing companies.

Generally speaking, as we have already noted, the high marginal income-tax rates tend to discourage investors from purchasing relatively risky assets such as common stocks, provided that the motivation for the purchase is to obtain an adequate income yield. On the other hand, the large differential between the income-tax rates and the capital-gains rates tends to stimulate the purchase of securities believed to offer good prospects of capital appreciation. On the assumption that opportunities for capital appreciation are regarded by investors as being relatively greater for investments in promising small companies than for investments in the stock of large, established companies, it could be argued with considerable force that the existing personal income-tax structure tends to narrow the relative advantages of the established company in obtaining outside equity capital over that of its small but more rapidly growing competitors. If this reasoning is accepted, it follows that this aspect of the personal income-tax structure tends to offset somewhat the overall impact of the tax structure that seems definitely to be in the direction of promoting greater industrial concentration.

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6. CONCLUSIONS

Our general conclusion is that the tax structure of recent years has tended to increase levels of concentration within the corporate sector of the economy and among all business firms, but that these tax effects have been of relatively moderate proportions. This is not to say that the level of concentration itself has increased. As we have repeatedly stressed, taxes are only one factor among many that have affected the level of industrial concentration, and it appears highly probable that the nontax factors at work have been considerably more powerful than the tax factors. We leave it to other participants in this conference, however, to appraise the direction and scale of overall changes in the level of industrial concentration. Our conclusion is simply that the net effect of the tax structure has been to produce higher levels of concentration than would otherwise have obtained.

The high rates of the corporate income tax during recent years appear to have been by far the most important feature of the tax structure tending to increase the level of concentration. To the extent that this tax has not been shifted, it has restricted the growth of successful small companies much more severely than that of larger concerns. This conclusion applies to the effects of the tax on the availability of outside capital as well as on internally financed growth, although the latter is of greater importance. This restrictive effect of the tax has been especially marked with respect to the growth and growth potential of the more vigorous and promising concerns with the best chance of effectively challenging the established positions of their dominant competitors.

The personal income-tax structure, on balance, appears to have had a much less marked effect on industrial concentration. True, the high rates at which ordinary income is taxed have tended in the various ways noted to increase the level of concentration. The relatively favorable treatment accorded long-term capital gains, however, has tended to offset some of these effects; in particular, it has tended to increase the supply of venture capital available to companies with outstanding growth prospects. When these counteracting effects are offset against each other, it appears unlikely that the personal tax structure as a whole has exerted a powerful effect in either direction on industrial concentration, though on balance it has probably tended to increase rather than to reduce existing levels of concentration.

Mr. ADELMAN. Just as a matter of clarification, I didn't understand myself to be in disagreement with you, either.

Mr. MILLS. I wanted you to say that you were in agreement.

Mr. ADELMAN. I have no doubt personally that the tax system does have a bias in favor of the larger and of the established firms. It may not be very great.

Mr. MILLS. Do you know where it is or why? I am seeking within the structure of the tax itself to locate those things that do cause this result.

Mr. ADELMAN. I think it is simply the size of the tax, plus the nature of the growing enterprise—its uncertain and speculative fortunes—that is responsible for most of it. But I have to add right away that while this is not altogether just opinion, it is mostly opinion and I cannot say that it has been established beyond any doubt.

I wish a little more attention would be given to these less spectacular biases, and less attention perhaps to mergers that make the headlines. My reason is that I think this year-in, year-out sort of bias is a lot more important.

Mr. MILLS. It can be more detrimental.

Mr. ADELMAN. Yes, and above all it works all the time and everywhere. An occasional merger here and there can be stopped, I think, by proper selective treatment under the antitrust laws.

Mr. MILLS. Do you think a large part of this difficulty on the part of small or new businesses may be found in the high rates?

Mr. ADELMAN. In the high rates themselves.

Mr. MILLS. I get that from the operators of small business to a greater extent than any other element of the tax structure.

Mr. COHEN. I would like to suggest that the principal problem of the small business is the one of securing capital for its operations.

Mr. MILLS. That is a problem, but there is also this problem, Mr. Cohen, that disturbs me. Since the small or new business does not have the capital within its own framework, we don't give it the opportunity to retain earnings to the extent that perhaps may be justified if we expect growth out of that new or smaller business.

Now, isn't that a fact?

Mr. COHEN. I am not concerned about the section 102 problem in this type of case.

Mr. MILLS. I am not talking about that. I am talking about the fact that when a small or new business finds itself making a hundred thousand a year, we are taking some $46,500 of that immediately, without regard to our desire for growth on the part of that business, and yet, we are taking substantially this same proportional amount from the larger corporation, but the mere fact that we take the same amount percentagewise does not always indicate to me that we are treating businesses of different economic level comparably. We are not in the realm of economics now. We are in the realm of necessities as I see it. Dr. Hall?

Mr. HALL. May I make a comment, Mr. Mills?

It seems to me that we have quite a little discrimination in favor of the small corporations, small as measured by the amount of its income. The small corporation, of course, to the extent it doesn't have, let's say, any more than $25,000 of income gets off at the 30 percent rate whereas income going to a corporation in excess of that amount is subject to surtax, which, of course, means an applicable rate of 52 percent.

Mr. MILLS. But they always get that. All corporations are alike.

Mr. HALL. In terms of contrast of rates we find applicable effective rates on corporate income ranging from 30 percent to slightly less than 52 percent.

Mr. MILLS. The effect on the small corporations might be less than on the bigger corporation, but by the same token we may still have, not an inequitable situation necessarily, but a situation that will not permit the growth on the part of the new company, or the small company, that we may have to have to enjoy the rate of the growth here in the United States that we hope to attain in the next 10 or 20 years in order to maintain as high a degree of employment as possible.

Mr. HALL. May I raise another point in this regard, Mr. Mills? In talking of new and small business—or small business, whether it is new or old—it seems to me that we have overlooked one category which is of some considerable importance. We speak of the small business problem with reference to the small corporation. We have many thousands of partnerships and proprietorships.

Now, of course, it is more difficult for these partnerships and proprietorships to retain and build from their own earnings for growth than the small corporation, generally speaking.

Consequently, if we are thinking of treating business income equitably and encouraging the growth of small business we ought not to overlook the proprietorships and partnerships because of the number of those enterprises and the extent to which they contribute to the gross national product.

Mr. MILLS. Absolutely.

You cannot do something for corporations under the guise of helping small business, in my opinion, without extending the same treatment to proprietorship operations. Otherwise, you either force proprietorship into the corporate operation, or you extinguish proprietorship operation by competition. Is that what you are saying.

Mr. HALL. In general, yes.

Mr. MILLS. I think you are right.

Now, let me ask you this question if I may, unless there is some further comments on the questions and statements so far.

What do you think about the possibility of having the normal corporate tax rate on a given number of dollars of earnings—whatever you decide you want to have taxable at only normal rate—equal to the first backet rate under the individual income tax, and then have for the surtax rate, whatever rate is needed, to obtain the additional revenues from corporations that your level of expenditures in a given year may require.

For example, if you retain a 52 percent rate on corporations, you would have a 20 percent normal rate, and a 32 percent surtax rate, or if you want it at 50 percent, you would have a 20 percent normal and a 30 percent surtax rate. Would that be in the interest of small and new business?

Mr. COHEN. You are talking, aren't you Mr. Mills, of basing the lower rate upon the first $25,000 of income?

Mr. MILLS. Or whatever it is you would want to subject only to your normal rate and to your surtax rate.

Mr. COHEN. Yes, but at the present time, the differential between 30 percent and 52 percent—22 percent on the first $25,000 of income—is $5,500 a year. That does not represent in my judgment a significant factor in the competitive standing of a small business as against the large business.

Mr. MILLS. Let's take one of $50,000. That is still a small business; isn't it?

Mr. COHEN. I think it is, but there the $5,500 differential is of even smaller significance.

Mr. MILLS. I don't agree with you Mr. Cohen, on that. I don't want to have the record indicate that I do agree with you. I think it is a material difference.

Mr. COHEN. The difference of $5,500 a year will not represent such a material difference in the success or failure of the $50,000 company.

Mr. MILLS. It might well mean more to that small business than a million dollars to another business of much larger size. You can't view these things, in my opinion, strictly on a percentage basis, of applying the same percentage to a small business and to a large business. That is what I have been trying to get over, to see whether I am right or wrong.

Mr. COHEN. Perhaps I did not state my point correctly. I was trying to say that $5,500 a year on a $50,000 income is of smaller significance than $5,500 on $25,000. It is mathematically correct.

Mr. MILLS. I misunderstood you.

Is there further comment on this point?

Dr. Hall?

Mr. HALL. Well, if I understand your suggestion correctly, Mr. Mills, you would have a normal tax rate, say, of 20 percent with a surtax rate applicable to all corporations a function of the revenue requirements at any given time, or taxable year. It may be that the combined normal and surtax rate may be 50 percent on corporations, 1 year, it may be a lesser amount or possibly a greater amount some other year.

It would seem to me that simply splitting the rates and distinguishing a normal and a surtax rate would of itself not be very important. The important thing, it seems to me, is the level of the tax rate or rates. There is also the problem of rate instability over time. If this were to involve substantial corporate-tax-rate uncertainties we could add to business risks.

Mr. MILLS. You could effect that more by increasing the amount of earnings that is only subject tothe normal tax and limiting the earnings subject to the surtax.

Mr. HALL. Then you get into tax discrimination with reference to corporations; do you not?

Mr. MILLS. No. To accomplish your purpose of determining the over effective rate, you might better do it—I am asking a question—by increasing the $25,000 to $100,000? Is that what you are saying?

Mr. HALL. No. What I am saying, if I make my point correctly, is this, to have a combined normal tax and surtax would of itself not be important. I would be concerned with the level of the rate or rates.

Mr. MILLS. That is what I am talking about.

You would be concerned with the aggregate and one way to determine the aggregate of the rate would be that portion of the income which is subjected to the surtax, wouldn't it?

Mr. HALL. That is right.

But in the process of doing this sort of thing, we, of course, establish the amount of the discrimination involved as between and among corporations having varying amounts of income.

Mr. MILLS. Let me ask this question, then I am through. I am sorry to ask so many, but what is the advice of the panel to the subcommittee in the way of general principles that the subcommittee

might adopt for economic growth and stability that will permit an atmosphere for greater competitive opportunity by small and new business, aside from the things that you have included in your paper? Do you think of any tax policy that you might suggest that this committee could adopt to recommend to Congress?

Mr. LINTNER. You phrase the objectives of the policy as being growth and stability, and more vigorous and effective competition. Did I understand you correctly, Mr. Mills?

Mr. MILLS. Yes, creating the atmosphere wherein that may occur.

Mr. LINTNER. Within that context I think it is clear from the studies that Professor Butters and I have made that one of the most important things would be to lower the level of the corporate tax rate.

In making that comment, though, I would like to point out that probably—I should think personally—that the committee would also be interested in considerations of revenue and equity as well as the two very important objectives you state.

Mr. MILLS. We are in a very enviable position in this subcommittee of being able to think in terms of economic growth, without undue pressures upon us with respect to revenue.

Mr. LINTNER. In that case, in terms of that objective, and the viability of competition, our findings indicate that the high corporate tax rate as such does discriminate in favor of the large, established corporation as against the smaller firm—particularly the vigorous, thriving small business that would be most likely to contribute most to more intensive competition. For that reason I would have placed the level of the corporate tax rate in the context you set as being the No. 1 consideration.

As an incidental point, referring back to the earlier discussion, the corporate tax rate—the effective rate defined simply as dollars of tax divided by dollars of income—was as high or higher for firms in the one- to five-million-size class, as for all larger size classes.

Below $1 million though, as a result of the variety of provisions in the tax law, the effective rate within corporations was lower for the smaller firms under 1 million, and increased as you approached 1 million. The overall picture was of a U-shaped curve, upside down, starting relatively low for the very smallest profitable corporations—I am leaving out deficit companies here—and increasing up to the 1- to 5-million-size class, and then either extending out horizontally or declining slightly. Very generally in most years, there has been an increase in effective rate as you move to larger firms, but only so long as you confine your attention to companies under a million in assets.

I though that that might help put some of the earlier discussion in context. The figures are included in this paper that I submit for the record.

Mr. MILLS. Dr. Hall, would you care to add in line with the question I have propounded to what you have submitted in your paper?

Mr. HALL. Well, I should like to see as much consideration as possible directed to this problem of disparity, or differential taxation, of business income—that which is generated through the corporation, and that which is generated through the proprietorship and the partnership. It is all business income. It seems to me that insofar as we

can there is a claim to treat this business income alike, which we do not now do.

To the extent that we find that our present discriminatory taxation is, on balance, a positive factor with reference to corporate mergers—let's grant for the moment Professor Lintner's point, the mandatory partnership method of taxing private corporations may establish some inducement toward mergers.

As I stated previously, I do not think this would be serious in terms of the number of such corporations and the total assets involved, but there may be differences of opinion in this respect.

It would seem to me that if we have to depend upon our present unneutral taxation as a means of establishing a negative force against corporate mergers, then we have inadequate and inept protection against corporate mergers. There are better ways of preventing corporate mergers if we wish to prevent them.

What I am trying to say is this: That I do not think we should use discriminatory taxation as a device to prevent or to minimize mergers.

If we do not like mergers then we should approach the problem more directly, and I think more effectively.

Apparently it has been assumed, but I think wrongly, that our present discriminatory taxation has some measure of effectiveness in retarding mergers.

I seriously doubt that the removal of our discriminatory taxation actually would cause any particular increase in mergers than would otherwise occur.

I should also like to see insofar as possible, in maximizing long-term economic growth, the best possible allocation of our resources.

There are various ways of measuring growth. I have not yet found any single satisfactory index.

Mr. MILLS. We never did either.

Mr. HALL. It seems to me that growth may be visualized in terms of maximizing capacity and output under conditions of an optimum balance of the different commodities and services that we want—in other words, minimizing, insofar as we can minimize, misallocation of resources. To accomplish this result certain considerations, some of which we have discussed, are relevant.

One is this: I do not think we are serving long-term growth if by our present discriminatory taxation of income we tend to create a significant incentive for the hoarding of corporate income, rather than encouraging real investment or income distributions in the form of dividends.

I think the economy requires that corporate income which is not distributed as dividends should be directed to real capital formation.

In my judgment we have weakened the former section 102, now known as the accumulated earnings tax, and insofar as this is correct, we have an inducement for corporate hoarding and I think it operates as an economic drag, the dimensions of which are difficult to estimate. This is adverse to the growth of the economy.

Further that in order to get the best allocation of resources with growth, it is essential that we have a tax structure which operates in as neutral a fashion as possible.

There may be occasions when we would wish to use a tax as a positive or perhaps a negative instrumentality to serve some ulterior purpose. This should be a conscious act and we should be clear in

our minds that it is the best way of serving the intended purpose and, further, that it will accomplish this purpose.

I should like to see an effort made to throw the burden of proof, as it were, on anyone who proposes to support, or who defends, discrimination in income taxation.

I think the case is all for equality, insofar as we can serve it.

Now admittedly there are many instances where we can't. In the very nature of income itself and the diverse sources from which it comes, we have impediments which will never permit us to secure full equality and neutrality in income taxation. But insofar as an intelligent people can serve this objective, it will contribute to the growth of the economy and will give us a better allocation of our limited resources.

Mr. MILLS. When you refer to section 102 you really mean section 531 of the new code, do you not?

Mr. HALL. That is known as 102 in the 1939 code.

Mr. MILLS. You are speaking of 102 in the 1939 code. I want the record to be clear at this point.

Mr. HALL. Yes.

Mr. MILLS. Mr. Cohen?

Mr. COHEN. Mr. Mills, I have been sitting here wondering why we had some difference of views over the extent of the effectiveness of the $5,500 differential in the corporate income-tax rate under our present tax structure on the first $25,000 of corporate income.

I certainly do not mean to minimize the significance of $5,500 a year.

I think that perhaps it is due to the fact that we may be talking about two different kinds of corporations.

One is, say, the small company which is making net after deducting salaries of the officers and stockholders, and depreciation, and so forth, something under $25,000 a year, has been doing so for the last 10 years and probably will be in that category for the next 10 years.

This is the corner-store type of business that may be incorporated, in other words.

I think that to this type of company, this differential is of vast importance.

The other type may be the small business which is on its way, and hopes soon to be a large business. I think that that business may be the one with which I have had most experience in my practice, and the problems of that business as I have seen it have been that of attracting capital. As to attracting capital, I do not believe that the people who have considered investing in it are too concerned about the differential of the $5,500.

They will invest only if they think there is a real opportunity for substantial appreciation in the company, and feel that this company will get out of the category of a small business—at least into the category of a medium-sized business, where the $5,500 will be of proportionately less significance.

Mr. MILLS. Let me ask you this now. You and I are prospective investors. Don't you think we would be a little happier about the prospects of investment in a company that might be able to retain a little higher share of its earnings for growth and expansion?

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Mr. COHEN. The reason why I do not is that I think that if I had a certain amount to invest, I would be inclined to invest it in a blue chip situation, rather than take the risk of investing in a small business, unless I had an opportunity for really substantial appreciation.

Mr. MILLS. I was thinking in terms of you and me being a rather venturesome and risky pair, who were more interested in the profits from such a venture than we might get through investment in blue chips. I was thinking not in terms of the overall advisability of how we invest, but that we had already made up our mind to invest in a small or new business, and I should think that we would be more attracted to companies that were permitted to retain a higher share of their earnings for growth purposes, even though in the instance you give it might not amount to more than the $5,500 of retained earnings. I would be more happy about it if that $5,500 could be retained, I think.

Mr. COHEN. I share your happiness, I am sure, but I think there is not a climate today in which there is an attraction for private capital to go into smaller corporations where the genesis of the company, the driving force of the company, comes from a young fellow who has an idea and has the will to work, and wants to put it over, and needs money from someone. He has great difficulty in attracting that today. It is much easier for that money to flow into public issues of large corporations, or natural resources, or tax-exempt securities, or something of the type; you have no climate, it seems to me, for it going into the smaller business for this young man.

I would like to see it go in there.

Mr. MILLS. Mr. Adelman, do you have any comment to make?

Mr. ADELMAN. Addressing myself to the general problem, the competitive tone of the economy, an easy answer would be that you ought to drastically cut down or repeal the corporate tax, and I suppose this would be worth about as much as an easy answer is usually worth.

I do think that when, as, and if the time for tax reduction arrives—and I don't, incidentally, think that is now—most emphasis ought to be given to some attempt at reducing the corporate rate; and perhaps even before that time arrives, to try to finance that reduction by removing what some of the other panelists seem to think are a kind of jungle of special provisions that have grown up into the revenue code.

Mr. MILLS. In other words, you are saying this: That when the time comes for tax reduction, which we are perhaps in agreement is not at the moment——

Mr. ADELMAN. I don't think so.

Mr. MILLS. We should not be unmindful of the problems of small and new business as we are not unmindful of the problems of the low-income individual taxpayer?

Mr. ADELMAN. That is right.

Mr. MILLS. That is about what you are saying; isn't it?

Mr. ADELMAN. Yes, sir.

Mr. MILLS. Mr. Curtis, I want to apologize for delaying your interrogation as long as I have, and I want to say for the record that Mr. Curtis served for some time as a member of the House Committee on Small Business, and should have led this discussion in the first place.

Mr. CURTIS. Not at all, Mr. Chairman.

I have been very much interested in the development of these thoughts. I am going to try to pick up where this present inter-

rogation ended, because I am not entirely sure I agree with the conclusions on the capital formation.

It would be my observation, with the differenential—and it is the differential that makes the difference—of the 52-percent corporate tax, and the 20- to 91-percent individual tax, the difference between those, and the 25-percent capital gains tax, between those figures, which, incidentally, can be a zero tax if the investor holds until death, it is that differential which actually is providing a tremendous amount of capital for small businesses. That is an observation that I make from personal knowledge, but I don't know; like anything you make from personal knowledge it could be just limited to the sphere of your observation and not be a general picture.

I know time after time we have gotten capital for small businesses, from people who have got a lot of money, want to get it into some place where they can have it grow, and so gain the benefit of a 25-percent tax, or zero percent over what they would have to pay—91 percent.

I wonder if my personal experiences there are out of line with other observations, or what is actually happening? Mr. Lintner?

Mr. LINTNER. Mr. Curtis, I might comment on that briefly.

The early studies that Professor Butters and I did 10 years ago on the effect of taxes on growing enterprises, found a substantial number of such cases. The more recent study which Professor Butters did with Professors Thompson and Bollinger have found that this venturesome group was a major category of investors, and that this differential in rates was a major stimulus to a flow of funds, capital funds, outside capital, to small business with a future, or thought to have one.

I think Professor Butters was here Monday, and gave testimony that probably involved that point. I haven't seen the record or talked with him since. Certainly the underlying volume, the effect of taxes on individual investors, contains a great deal of solid, factual evidence, regarding this point, and a copy probably is already in your files. If not, it could be made available.

Mr. CURTIS. I am very happy to hear that. I hasten to add, for a lot of other reasons these differentials, in my opinion, are producing economic results that I don't like to see, but at least as that one particular thing bears that happens to be on the affirmative side of small business.

Mr. LINTNER. I might add one further comment. The comparison of rates that provide the incentive is the differential between the personal tax rate and the zero, or 25 or 26 percent, capital-gains tax.

The differential between the corporate rate on ordinary income and on capital gains affects decisions in some marginal cases, but in connection with the problem that we have been primarily discussing, this is incidental and can probably be dismissed. The comparison between the personal-tax rates and the capital-gains rate is the important matter.

Mr. CURTIS. I would agree with that. Actually that 52-percent rate, to my judgment, comes into more in the question of how the corporate financing is to be, whether it is to be in borrowings or whether it is going to be in equity, because if it is in borrowings, say someone goes in and gets the equity of a small concern, or any concern, gets the equity of a small concern, and it will be his desire or that group's desire to finance growth through borrowings, because the

interest is deducted from the 52-percent rate, but that hasn't a particular bearing on this point.

I am going on to discuss or mention some things where I do believe that the tax structure is actually putting small business at a disadvantage, but before I do it I wanted to get on to this discussion that I followed sort of out of one ear, on the effect of that dividend credit as far as it relates to small business. But in order to understand it, first, I wanted to discuss it in the light of possible revenue loss to the Federal Government, because I personally do not believe, if the theory is right, there will be a loss. In fact, I think there will be a gain, and here is why I said that: At least the idea in my mind of the dividend credit was to switch corporate financing from an emphasis on borrowings to equity, and also I might say to switch it from retained earnings, which, of course, is equity, to new issues, new equity issues.

Now, I don't know as that result has come about in any way at all, but if it were to come about we would have a revenue gain because retained earnings would be converted to dividends rather than used as capital growth, and so the 91, or the 20 to 91 percent tax, personal income tax, would apply instead of this 25 percent or zero percent capital gain. There is indication in my judgment that this dividend credit has produced some flow into the dividend dollar as opposed to using the retained earnings for growth.

Secondly, as regards to debt financing, a switch from $1 billion, for example—taking an overall figure for a lot of corporations—$1 billion of debt financing, from debt to equity would—say it were $1 billion, $40 million for 4-percent bonds—$40 million earnings would then be subject to the 52-percent corporate rate, if that switch occurred.

Now, in my own thinking I don't quite see, even if this were economically so, how it would in any way affect the small business in relation to the large. I think the size of the concern would have a little bearing.

Do you think there would be any particular difference in that if that were so, between large and small concerns?

Mr. Hall or Mr. Lintner, if you disagree with that——

Mr. HALL. As I understand the statement as you have made it, I don't think that size has any direct relationship to the problem. It would seem to me rather the desire and purpose of the controlling interest in the corporation. If, for example, the controlling interest in the corporation is concerned with the growth and development of that corporation, namely, increasing its size and its competitive status, then probably the dividend relief provision, whatever way it may be set up, would have little effect in inducing larger current dividend payouts. If, on the other hand, it is a private corporation that is being used in some degree for avoidance of personal tax, with some portion of the retained earnings not required for growth, a dividend relief provision, if substantial, may induce some, or larger, dividend distributions.

Mr. CURTIS. You don't feel there would be much bearing between the size? It would probably depend, as you say——

Mr. HALL. It does not appear to be a function of size directly.

Mr. CURTIS. Is there any disagreement on that, just on this question whether size would have any bearing, not whether my thesis is

right, but if anyone does want to object to my thesis I will be glad to hear that, too.

Well, now, then, what I am to develop or throw out for consideration, first of all I think that, of course, by the very nature of small business any Government tax or regulation puts a small business at a competitive disadvantage to a large business simply because of the need for personnel to cope with the tax or the regulation. The more complex the tax or regulation is the more disadvantage the smaller concern is placed, and that is a factor which I think is quite important.

Furthermore, the imposition that the Federal Government makes on small business as a tax collector has a great deal more bearing on his situation than does on the larger concern. Do you all agree with that observation?

Mr. HALL. Mr. Curtis, I may make a comment on that point. I think in passing what you have done is to suggest one not unimportant consideration in favor of further integration of the corporate and personal tax. Income-tax integration would, I believe, in some measure, simplify and reduce the burden of reporting income tax liability.

Mr. CURTIS. And any simplification, of course, would benefit presumably the small concern.

In developing that thought further, any particular tax benefit that might be granted would by its same nature benefit larger concerns than smaller ones.

Let me illustrate, a certificate of necessity. A large concern has a much better chance of getting a certificate of necessity, I would feel, than the small concern simply because it has got the personnel, lawyers, accountants, and so forth, to present a case. I would say an important thing in considering is this problem of simplicity as opposed to complexity.

Going on, I would say that it would be true of any differential that has been placed in the tax structure, and the differential—we have been playing around with the words "differential" and "preferential" here in our previous discussions. Of course, any differential can become preferential. I am sure that many of our differentials have become preferential under our tax structure. The smaller business is placed at a disadvantage in regard to those, too, I would say.

Would the panel agree with that observation?

Mr. LINTNER. I might comment that the objective of simplification and the objectives of equity we all agree that simplification and minimum compliance cost are desirable; the costs of compliance are probably relatively greater for smaller firms than for large. But these, again, are objectives of an ideal tax structure that have to be weighed against their costs in other respects, equity, growth, and so on.

Professor Hall feels that integration to a mandatory basis, incorporates all financial partnership returns which are identical individuals, would simplify the law. I suspect that the technicality and complexity of the provisions that would be necessary in order to set up such a partnership treatment for even private corporations would be horrendously baffling. Apart from that, we have already mentioned the probable stimulus to mergers which I at least would anticipate from such a requirement. Also, the smaller business which has a future and is vigorous would be moving rapidly into the pro-

gressive section of the personal tax rates, and this would probably often inhibit investment even more than the corporate rates.

I would anticipate that Professor Hall's proposal—granting for the moment that it might be a simplification, which personally I would doubt—would defeat the other objective of really giving an even break, if not a preferential treatment, to small business as such.

I think it would point definitely in just the opposite direction and probably compromise our objectives of the growth and higher investment.

Mr. CURTIS. I am happy for that observation because I think it points up what I am trying to get at as far as this committee is concerned. We are trying to consider the economic effects of our tax structure, and I think this committee could very wisely come to the conclusion in our observations for the benefit of the Ways and Means Committee and the Senate Finance Committee, that almost as a rule of thumb, the more simple our tax laws are the better break the small businesses get and the more complex they are the more disadvantage they are going to experience, so even where we pass laws that we think are going to give small business a break, if they make the whole system more complex, we might not actually be doing that.

I have observed in the House Small Business Committee that we on several occasions did exactly that sort of thing in other kinds of laws. We passed legislation we thought was going to benefit small business, but because we made the whole thing more complicated I doubt if we achieved our results.

Mr. LINTNER. If I may add one comment, I think that in getting simplification, even if you achieve it, you might defeat some of your other purposes with regard to small business; and even if you accomplish those, you might well defeat still other objectives that also were in the interest of public policy.

Mr. CURTIS. I agree with that. I am keeping one factor before us. It is true that things that make for complexities are not idle things and we perforce have to put complexities in the law but I believe just as this one factor of simplicity as opposed to complexity being adverse to small business to be true. That would only be one factor, and possibly a minor one, but on the other hand it is a factor that I think has to be borne in mind, and I think we have a tendency not to bear it in mind.

I wanted to go on to a specific area where I think our small businesses really are at a disadvantage, and I think that our tax laws are a contributing factor, and that is in the competition for personnel, top personnel in particular. We have written into the tax laws these various provisions for pension plans, deferred-stock plans, and so forth, which seem to me to be readily available to our larger concerns, but not so readily available to our smaller concerns.

Does anyone care to comment on that observation?

Mr. HALL. Do you not think, Mr. Curtis, that in case of the small corporation, the promoters, owners, and managers—usually identified as the same individual or individuals—expect to get their pension or their retirement annuity, whatever you wish to call it, out of the competitive success of the growing enterprise?

Mr. CURTIS. Yes.

Mr. HALL. In the case of the large corporation where you have an employed management, where there is perhaps little identification with ownership, such an employed management must be compensated with reference to provision made for retirement in a somewhat different manner.

I have never felt that the small corporation was at a special disadvantage in this respect, provided the small corporation were successful.

However, there are many unsuccessful corporations. As a matter of fact in Statistics of Income for 1951, we find, with reference to income for that year, that 46.5 percent of the reporting corporations (with balance sheets) having less than $50,000 of assets, did not have any taxable net income. For the unsuccessful corporations—and they are numerous in the corporate universe—the owner-managers are running a hazard for the future.

Mr. CURTIS. Let me interject this, Mr. Hall. I think you are right so far as the owner-manager type. I was really thinking of some specific concerns, where possibly there are more medium-sized—take one I am thinking of in particular—that employs 75 people. It was a family corporation, but there were no sons ready to carry it on. The family wanted to continue, and they wanted to attract a particular individual by offering him certain benefits. Well, they were not in position to compete with a larger concern for those services, mainly to a large degree because of these various programs that are available under our tax laws to the larger concerns. I think there is a large area of small business that fits in there. I may be wrong, but that is what I posed the question for.

Mr. HALL. For that general group of corporations I think you have a very good point, Mr. Curtis.

Mr. CURTIS. They hire certainly under a hundred people and they have got a problem of top personnel. Incidentally, Mr. Mills and I have gotten in our studies of taxation of life-insurance companies, we have found that in this business of pension plans where the large corporations can set up as trustee; he gets the tax benefit but your smaller concern, having to go to life-insurance companies in effect has to pay a tax, and on that basis he is at a dollars-and-cents disadvantage. It costs him more.

That is one of the areas. What I am driving at, though, is the very question that Mr. Mills posed. As we look at the tax structure, of course, what we are ultimately trying to do is to provide a climate of equal competition between small and large, and to be certain that to the extent that our tax structure enters into the picture, that it is neutral.

Well, now, if it isn't neutral, then we put in what is a differentiation and the differentiation to be good must actually reflect an economic reality. There is our trouble, when we put in that differential on something that is so intangible, so difficult to figure out, it can easily become preferential, and I don't think small business or anyone really wants to give a preference to small business. It is a climate of equal competition.

I don't know that we can find the answer. It may be just in the nature of things. I wonder whether we really can find this differential in such a way that we can put it into the tax laws.

Mr. HALL. One of the problems, Mr. Curtis, that has disturbed me is that we may have differentiations which involve subsidies through our tax laws, thus encouraging uneconomic operations and unwise use of our limited resources.

Mr. CURTIS. In a sense I am quibbling over words. Using the word "differential" to mean that which accurately reflects an ecoonmic situation—let's take on depletion of gasoline and oil. It was put in on the theory that it was actually reflecting something which is hard to measure, but an economic reality. To the extent that it would accurately measure, I would regard it as a differential. To the extent that it is unrealistic it could become, and many people argue, is preferential, so that is the way in which I would use the two words. What I think you are saying, and I agree with you, if we get these things in that are preferential really, then we do produce an uneconomic result when we get a preferential thing in there. But my observation would be in searching for an accurate differential, which would be a fair measure of this economic situation in our tax structure, I fear that we might get into such complexities that, due to the fact that we are disobeying the law of simplicity, which would help the small businesses, we would tend to be defeating our purpose in trying to get the differential for small business.

Mr. COHEN. Mr. Curtis, using the case that you put, of the small company with, say, 75 employees trying to attract a top executive, I believe that there are opportunities open under the tax law for, say, a medium-sized company of that type, to attract a man. I don't find in the tax law itself obstacles to attracting an executive, if all other things are equal. For example, such a company can offer a man a stock interest in the company. If he is not able to afford a substantial interest because the stock is too valuable, we can sometimes recapitalize the company so as to have both preferred stock and common outstanding, reducing the value of the common stock sufficiently to allow the man to purchase a substantial interest in the company.

In that way, you can sometimes equate the closely held company situation to that of a stock option plan that a large company might be able to offer. It may not provide all of the advantage, but it can still make it attractive.

Mr. CURTIS. One trouble on that, as I understand it, the fact that you are not apt to have a value for your stock in your smaller concern. The big concern has, because it is on the stock market and not having the value, you get into the problems with your Bureau of Internal Revenue on this kind of plan.

Mr. COHEN. I think you do get into a problem of that kind, but I believe the problem is more administrative than it is in the law itself.

Mr. CURTIS. I think you are right as far as the law itself imposes an administrative problem that is pretty difficult, and in some ways almost impossible for the small concern to meet—not impossible, but I mean very costly, and complicated.

Mr. COHEN. It sometimes can be more attractive to a man who may be willing to take a chance on something of that type than on a stock-option plan offered him by a large corporation, because if this man has the opportunity to go in and direct the business, the rise in the value of the stock can be more directly attributable to his own efforts than would be the case if he had an option on a tenth of 1 percent of the

stock of the large corporation, which might go up or down in value wholly irrespective of his own efforts.

There are also other types of things, such as profit-sharing trusts.

I think that the main differences, from the standpoint of attracting men, lie in the fact that it will not be as stable a situation as a large company, and the stock interest will not have a ready market. When he wishes to dispose of his stock, he may find that with a 10-percent interest in the company he can't liquidate his interest. He is just a minority stockholder, whereas if he had a tenth of 1 percent interest in a large company listed on the New York Stock Exchange, he could get rid of it at any time. I am not sure that that is a tax differential as much as it is a fundamental difference between the company whose stock is listed and a company whose stock is not.

Mr. CURTIS. I think that is a very good point.

That is all I have, Mr. Chairman.

Mr. MILLS. Is there anything further—any further comment by members of the panel? If not, the Chair wishes again to thank you for your appearance today and the contribution you have made both in the compendium and in the course of the hearings this afternoon. We appreciate very much your taking the time to be with us and helping us in this problem.

The subcommittee will stand adjourned until 10 o'clock tomorrow morning.

(Whereupon, at 5:25 p. m., the subcommittee adjourned, to reconvene at 10 a. m. on Thursday, December 15, 1955.)

FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

THURSDAY, DECEMBER 15, 1955

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON TAX POLICY OF THE
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The subcommittee met at 10 a. m., Hon. Wilbur D. Mills (chairman of the subcommittee) presiding.

Present: Senator Paul H. Douglas.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The subcommittee will come to order.

This morning's session of the Subcommittee on Tax Policy will be devoted to discussion of the relationship of taxation of income derived abroad to foreign economic policy.

As was announced yesterday, our procedure is to hear from the panelists in the order in which their papers appear in the compendium Federal Tax Policy for Economic Growth and Stability.

At the start of each of these sessions, panelists will be given 5 minutes each to summarize their papers. We will hear from all panelists without interruption. The 5-minute rule will be adhered to. Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session. I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee's questions.

Our first panelist this morning is Prof. Roy Blough, of Columbia University.

Mr. BLOUGH. Mr. Chairman, the present drive to reduce tax rates and grant other tax concessions for income attributed to foreign business operations is being supported by arguments on grounds of fairness and arguments on grounds of foreign economic policy.

In my earlier paper published in the compendium I dealt only with the relation to foreign economic policy.

The arguments on grounds of fairness are being made chiefly by the businesses which would receive the concessions and should be examined with great care from the viewpoint of the effect on the general interest.

The basic principle of fairness underlying the Federal income tax is that the amount of tax should be determined by the economic status or ability to pay of the taxpayer and not by the industry or the geographical location of the business activity.

I suggest that this principle calls for equal taxation of income from business done at home and from business done abroad, as has been the major line of policy in the Federal income-tax law.

Proposed tax changes which would support that principle should be distinguished from changes that would undermine it. Much testimony has been presented to your committee showing that whenever the principle has been breached the result has been injurious to the fairness of the tax system, to the revenue, and to taxpayer morale.

In the 5 minutes allowed I cannot go into specific proposals and will leave those for discussion later.

Arguments relating to specific cases of alleged unfairness are difficult to meet because it is almost always possible for any taxpayer to make a showing that he is being treated unfairly in one or more respects in comparison with some other taxpayer or taxpayers.

The solution proposed is always to reduce the taxes of the less favorably treated, never to increase the taxes of the more favorably treated. It is the sad history of Federal taxation that reducing the taxes of particular taxpaying groups to eliminate unfairness is a never-ending process, and that every effort to meet the demands of one group of taxpayers leads to new demands by other groups and often by the same group.

The other group of arguments is that tax reduction and other tax concessions with respect to incomes from business carried on abroad would constitute incentives which would stimulate private foreign investment, thus promoting the foreign economic policy of the United States.

This argument has been made by the administration, by representatives and organizations of businessmen, and by the representatives of some foreign governments.

It should be noted that tax incentives usually cause unfairness among taxpayers, such unfairness being defended on the grounds that it is outweighed by the economic benefits resulting from the incentive.

I agree that increased private foreign investment would be desirable, although I think its importance, from the viewpoint of the United States, has been overstated and oversold by some people.

The chief question with respect to tax incentives, however, is whether their price would be too high for the results they would achieve. The price is not merely the loss of revenue from the income on investment that would actually be brought into being by the tax incentive. The price includes also the loss of revenue on all existing investment abroad and on all future investment that would have taken place in the absence of tax concessions. The price also includes the precedent that is set for other taxpayer groups to secure their own special tax concessions.

In view of the numerous obstacles standing in the way of private foreign investment in most of the world, the amount of increased investment that would result from the proposed tax concessions—for example, the Treasury proposals—is likely, in my opinion, to be relatively small. The studies which have been made thus far support this conclusion. I suggest that the price of tax concessions therefore may be too high for the results that may reasonably be expected from them.

There is, moreover, the danger that we may persuade ourselves that granting tax concessions will meet the responsibility of the United States for the economic development of the rest of the free world, which our foreign economic policy deems so important. When the results of tax concessions were found to be too little it might then be too late to do the other things that need to be done.

If it is decided to grant some additional tax concessions, those concessions, it seems to me, should be in the form of deferring the payment of tax, under appropriate safeguards, during the period the income is reinvested abroad, but not by reducing tax rates.

Tax deferral places the incentive at the right point, namely, on increasing the investment abroad. Deferral makes it relatively unimportant to distinguish investment income from the profits on exports, which, in my opinion, do not qualify for tax concessions.

Moreover, limiting the concession to deferral of payment might forestall periodic future political pressures to reduce further, and finally to wipe out, Federal taxes on income from United States business operations abroad.

Thank you, Mr. Chairman.

Mr. MILLS. Our next panelist is Mr. Ira T. Wender, Lord, Day & Lord, New York, N. Y.

Mr. WENDER. I think it is generally agreed that any proposal for tax relief to a particular segment of taxpayers should bear a heavy burden of proof. Such relief erodes the tax base. Moreover, as it is always necessary to limit the taxpayers entitled to the relief, pressure quickly develops for the extension of the relief to other groups who usually claim with some justice to be equally entitled to the special treatment. This, in turn, leads to a further erosion of the tax base.

While the case for tax relief to foreign investment has been most ably presented by some of the panelists, I am by no means convinced that the arguments made in its behalf show convincingly that such relief is required.

To decide that relief for foreign source income is unnecessary, is not, however, a complete answer. The present system of taxing foreign income is anomalous in that the same economic activity is taxed at widely different rates and at different times depending on the legal form in which the activity is conducted. A domestic corporation is currently taxable on all its income derived from foreign sources, but the rate of tax imposed may be 52 percent or, if it qualifies as a Western Hemisphere trade corporation, 38 percent. On the other hand, if the same activity were conducted through a foreign corporation, the foreign source income would not currently be subject to United States tax.

This deferment of United States tax which results from foreign incorporation can be exceedingly important. If a domestic corporation invests in a country with a low-tax rate, more rapid expansion out of retained earnings after tax is possible, than if the higher United States tax were paid.

Deferment can also operate advantageously in cases of investments in more than one foreign country. If a domestic corporation with a foreign subsidiary uses the subsidiary's profits to finance a new foreign investment, United States tax is imposed on the withdrawal of funds in the form of dividends from the foreign subsidiary to finance the

new investment. But if the stock of the foreign subsidiary were held through a foreign holding company, organized in a country like Canada, Liberia, or Panama which imposes no tax on such dividends, the subsidiary's earnings could be used to finance the new investment without the imposition of United States tax.

While the advantages of the privilege of deferment can be substantial to expanding firms, they are not available to all foreign investors because it is practically impossible to transfer the stock of an existing foreign subsidiary to a foreign holding company without imposition of substantial United States capital gains tax.

Furthermore, for public relations reasons some companies are unwilling to use holding companies organized in tax haven countries. The privilege of deferment has also been abused by some. Too frequently earnings of foreign subsidiaries are permanently withdrawn by the parent corporation in the forms of loans, rather than dividends, to avoid imposition of United States tax.

Obviously, two approaches are open to the development of a more rational tax regime for foreign income. The first would be to eliminate the privilege of deferment of United States tax on income of foreign subsidiaries. This would, however, raise a constitutional problem in that it is not clear that the United States would have jurisdiction to tax the income of a foreign corporation.

Furthermore, such an approach would be contrary to the traditional tax jurisdictional concepts of American law.

Alternatively, the deferment privilege could be extended to all foreign-source income regardless of whether a foreign or a domestic legal entity were used as the medium for the foreign activity. The consequence of such an approach would be to equalize the tax burdens of all types of foreign activities and, thereby, to achieve a much greater degree of tax equity than adheres in the present system. The present abuses could be controlled by combining extension of deferment with more stringent regulation by the Internal Revenue Service.

As an incident of the adoption of deferment, a substantial incentive would be offered to further foreign investment by United States corporations. Moreover, the incentive, unlike a reduction in the rate of tax on foreign income, would directly relate to new investment.

A rate reduction gives a benefit to companies that are withdrawing from foreign investment, and to companies that are not expanding their foreign investment. Deferment is advantageous only to a firm that is expanding abroad. If the firm requires additional capital for new investments, it can, under a deferment plan, obtain that capital free of United States tax. On the other hand, a firm which is not expanding has no need to keep its funds abroad, but instead will repatriate those funds to the United States at which time they would be subject to tax at regular rates. Deferment in such a situation would prove no advantage.

It has sometimes been objected that deferment would be too costly in tax revenue. This objection is questionable since the United States firms are not now investing great sums abroad.

Moreover, most of the proposals for deferment provide that it would be extended through creation of a special class of domestic corporations.

These corporations would be required to file a tax return, but would be relieved of the necessity of paying tax until their income was dis-

tributed or loaned to the parent company for use in the United States.

Because of the requirement that a return be filed, the Treasury would be able to determine accurately the cost of deferment. If the revenue loss were excessive, the privilege could be withdrawn. Also, it would be possible to test the revenue cost of the extension of deferment.

For example, the amount of the tax, the payment of which would be deferred, could be limited to 50 percent until sufficient experience under deferment had been gathered to determine its real cost.

Mr. MILLS. Our next panelist is Mr. E. G. Collado, treasurer, Standard Oil Company of New Jersey, New York City. Mr. Collado?

Mr. COLLADO. Less, rather than more, United States investment abroad may possibly result from current legislative proposals to change the tax treatment of corporate income from investment abroad.

I say this despite my belief that a change is long overdue in the United States tax treatment of such income, despite the fact that appropriate measures were recommended last year by the Randall Commission and by the President, and despite the fact that the President has this year reiterated his recommendations, which include a 14-point reduction in the United States tax rate on corporate income from investment abroad.

There is now before the House a new bill, H. R. 7725, drafted by the Treasury. The bill does include the 14 point and other recommendations, but the bill has so hemmed those recommendations in with needless restrictions that only limited incentive for investment abroad would result from passage of the bill. What is worse, this limited incentive could be more than offset if the needless restrictions were subsequently extended to all private investment abroad whether or not made with the benefit of the new provisions of law.

The Secretary of the Treasury has stated for Congress some excellent general principles which should apply to the new legislation. Unfortunately, the detailed drafting of the proposed bill does not appropriately implement these principles.

For this reason it will be necessary in the coming months for the Congress in considering the proposed legislation to give careful consideration to details which might at first glance be dismissed as merely technical. In my paper in the compendium which was prepared for your use I have attempted to enumerate the details in proposed or existing law which are inconsistent with the objective of encouraging investment abroad. In each case a remedy is recommended to bring our law closer to the desirable state in which the same United States tax is imposed on a given economic operation abroad whether that operation is conducted through a corporate division, through a domestic subsidiary corporation, or through a foreign subsidiary corporation. In a number of cases these recommendations were agreed upon by all four members of this panel, as is pointed out in section 5 of our joint paper.

These technical recommendations are an important supplement to the rate reduction which should be the central element in the reform of the United States tax code as it relates to foreign investment.

The rate reduction itself should be adopted in fairness to the investor:

In Secretary Humphrey's words:

> At present, our business firms are at a disadvantage in countries with lower taxes than our own when they have to compete with local capital, or capital from countries which impose lower taxes on foreign income than we do.

The general rate reduction is also needed to remove a competitive disadvantage of some United States investors in relation to other United States investors. The geographic limitation on Western Hemisphere trade corporations arose in 1942 at a time when large areas outside the Western Hemisphere were under enemy occupation. The discrimination should now be removed, bearing in mind that the lower rate will not appreciably concern those investing in the developed, high-tax countries; Western Hemisphere trade corporations have not been active in Canada, for example.

The rate reduction should also be adopted in the interest of the United States economy:

Foreign countries are now under an incentive to increase taxes on the United States enterprises up to the level of United States tax rates. If the present tax system is unchanged, there might well develop a long-run tendency for the already small revenue from United States taxes on corporate income from investment abroad to disappear. A corporate rate reduction now could actually serve to increase the total revenue in the long run by increasing the revenue from the personal taxation of income which had its origin in an increased United States share of income earned abroad.

Moreover, a rate reduction will benefit the United States economy by facilitating investments which will provide the United States with economical supplies of those basic industrial raw materials which the growing United States economy will find it increasingly necessary to buy from abroad.

Finally, the rate reduction should be adopted as a contribution to the economic strength of the free world:

In the words of the President:

> Our own self-interest requires such a program because (1) economic strength among our allies is essential to our security; (2) economic growth in underdeveloped areas is necessary to lessen international instability growing out of the vulnerability of such areas to Communist penetration and subversion. * * * In that light, the flow of capital abroad from our country must be stimulated and in such a manner that it results in investment largely by individuals or private enterprises rather than by government.

Mr. MILLS. Our next panelist is Mr. John F. Costelloe, tax director, RCA, New York, N. Y.

Mr. COSTELLOE. Mr. Chairman, although the proposals vary considerably, they generally reflect belief that United States taxation affects commercial decisions of importance to the Nation, and that improvements are in order.

Some proposals concern the effects of formal matters, particularly the place of incorporation, and would permit a business organized as a corporation in, say, Louisiana, to fare as well as one organized in Lichtenstein or Libera—to mention but two currently popular tax havens. There are differences on how well it should fare. Some would permit only deferral of United States tax on foreign income while dedicated to the foreign venture, and others would add the benefit of rate differential. In general, the greater the proposed benefits, the stricter are the proposed tests of qualification.

Other proposals would give more assurance that the combined burden of foreign and domestic tax will not exceed the burden which would have been incurred in a purely domestic operation. These proposals principally concern the highly technical but intensely practical provisions for credits against United States tax for foreign taxes.

Other proposals concern the appropriate treatment of losses in foreign ventures, and the availability of special allowances, such as percentage depletion.

Still others concern the special problems of taxing individual, as distinguished from corporate income.

Evaluation of any particular proposal must usually rest on opinion and estimate, and not on demonstrable results. One may consider any tax benefit only as erosion of the tax base; another may consider growth potential assurance of accretion rather than erosion; and another may consider any fiscal aspects unimportant in relation to aspects of international relations.

I favor deferral.

And I favor rate differential, for reasons which I might group under the three R's of risks, rates, and relations. Commercial, financial, and tax risks in foreign operations are typically greater than in domestic operations. The combined burden of foreign and United States tax on foreign operations is often greater than would be incurred by a wholly domestic operation; and the relation of that burden to the tax burden of foreign competitors often places United States business at a competitive disadvantage, and occasions pressure on foreign governments to raise the rates of their tax applicable to United States business, to approximately the rates of United States tax applicable to domestic operations.

The present gap between foreign and United States rates, plus the provision for foreign-tax credits, occasions constant pressure for reduction, and I think it preferable that the pressure be relieved by lowering the United States rates rather than by leaving foreign countries under pressure to raise their rates to match ours. They should decide their own matters from the standpoint of their own problems, and circumstances.

I believe, however, that change, rather than choice among debatably preferable changes, is the most important matter now. Change will yield experience, and that in turn knowledge—which is our greatest need as the Nation emerges into a new position of world responsibility, for which present laws are inadequate, reflecting as they do in large part historical accident rather than current appraisal of present needs.

Mr. MILLS. On behalf of the subcommittee, I want to thank each of you for your appearance this morning, the information that you supplied the subcommittee in the compendium, and in your summary statements this morning also.

We appreciate the fact that you could find it convenient to be with us, as we have appreciated that fact on the part of the other panelists.

As I have said, at each panel appearance heretofore, our purpose in this study is to find the basic economic principles upon which we can base tax policy for economic growth and stability.

The subject-matter we are discussing this morning is generally regarded as important in considering the growth of an American economy.

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Expanding world trade is recognized as having an important bearing, not only on the level of economic activity in our country, but also on the efficiency with which we use any scarce economic resources available to us.

I have some rather fixed views about what we should do with respect to the encouragement of foreign investment—not in opposition, I want to state in the beginning, to the idea of foreign investment, but rather views based upon my own interpretations, I should say, of what things are needed to be done actually to encourage investment abroad.

Let me first of all ask the panel for the benefit of the record to follow through very briefly, as Mr. Wender has already done, and state just what is now done to encourage foreign investments.

First of all, we have a peculiar situation with respect to China corporations and we have a particular set of procedures with respect to Western Hemisphere operations, so for the moment, let's disregard those operations and speak in terms of the areas of the world where we have not extended some special differential, such as Europe, or such as sections of Asia, where foreign investment might be desirable.

First of all, we permit the American corporation operating overseas to retain any earnings derived in the subsidiary operation or operation there so long as that corporation may desire to do so without requiring taxation on the profits, until they are actually returned to the United States.

Isn't that correct?

Mr. WENDER. That is right.

Mr. MILLS. What else do we do, Mr. Wender?

I think I want you to help me at this point, because I am not unmindful of the fact that you have conducted with Mr. Surrey, while you were at Harvard, I think, a rather detailed survey of this situation.

What else do we do?

Mr. WENDER. Essentially except that by the act of foreign incorporation the United States tax is deferred, I would say we do nothing else. We do provide of course a foreign-tax credit.

Mr. MILLS. We do not provide any guaranties to American investors, or to American corporations against losses incurred in such foreign investments through changes in governments and things of that sort, do we?

Mr. WENDER. I was thinking of the tax area.

Mr. MILLS. We will go beyond merely tax provisions.

Mr. WENDER. I think it is ICA now, the ICA guaranties, under which—I am not too thoroughly familiar with this but I understand under it you can for a premium obtain insurance to protect against currency inconvertibility, and against the risk of expropriation.

I believe very few corporations relatively though have taken advantage of that.

Mr. MILLS. That premium cost is deductible as an item of cost for tax purposes I would presume.

Mr. WENDER. I would expect so.

Mr. MILLS. It is very limited, I understand.

In other words, we do not provide any assurances that there will be any safeguards against changes in forms of government that might cause complete losses of the investments overseas at the present time.

Mr. WENDER. That is right, except in the same sense, that if your

business were completely expropriated you would have a loss, which would be deductible for tax purposes.

Mr. MILLS. I wanted to bring that out. We will comment on that. How much assurance do we have in that respect?

What I am trying to lead to is this, so that you will understand the basis of my questioning.

I wanted us to have a complete picture of what inducements are now offered within the tax law and outside of the tax law to encourage investment of United States private capital overseas, if investment of United States private capital overseas is in any way contributing to economic growth here and I take it that it is.

After we have once laid the groundwork of what now is the situation, then I wanted to know about the extent of investments overseas, and whether or not we are realizing the extent of investments overseas that is necessary to the economic growth which we want, and then to find out what needs to be done with respect to tax policy to insure a continuation of that investment overseas, to the extent needed to maintain a stable and balanced growth here in the United States.

That is what I have in my mind this morning, if you members of the panel can keep in mind those various elements, and we will proceed, if you will, to a discussion of the problem from the viewpoint of those factors.

Mr. COLLADO. Mr. Chairman, could I make a one-sentence remark?

I think that in addition to certain incentives to foreign investment that have been mentioned here, or aids to foreign investment, the actual working of the tax law as we have pointed out in some of these papers in the compendium, tends in a number of respects to cause foreign investments which take a particular corporate form, for reasons other than tax reasons, to lose some of the privileges that are actually available to investment within the United States under the tax laws.

I think there are some disincentives here as well.

Mr. MILLS. Mr. Blough, will you begin the discussion of these matters from the viewpoints discussed by me?

Mr. BLOUGH. Mr. Chairman, one of the questions you directed the panel's attention to is whether investment overseas is sufficient for the economic growth of this economy.

Mr. MILLS. That is right.

Mr. BLOUGH. I would assume you have in mind distinguishing the relation of overseas investment to our economic growth from the benefits which our economy might gain through greater political and military security resulting from the stimulation of economic development in the less developed countries.

Mr. MILLS. I had hoped in the beginning we could think of it in cold, economic terms.

Mr. BLOUGH. Of course national security has its cold, economic terms also. A difference between war or peace, or a difference in the area of the world covered by communism, has its economic terms. But your question concerns what might be called the direct economic impact on the United States of our foreign investment, as distinguished from the benefits we might derive from increased political and military security, which although of economic importance, are less calculable and more speculative.

It may clarify the problem to consider the effects of United States private investment abroad on the American economy at three different times.

First are the effects at the time the investment is being made abroad.

When such investment is being made, additional purchasing power to buy American goods is being created abroad.

That, of course, stimulates our export businesses and increases their prosperity.

If that investment abroad is a substitute for an investment that would have been made at home, there is no net increase in total purchasing power, merely a substitution, so our economy as a whole does not get any extra stimulation.

Mr. MILLS. You mean no net benefit?

Mr. BLOUGH. No net benefit.

That is, we are losing the benefit from an internal investment and gaining the benefit from an external investment, but aside from that, and the fact that different companies probably would be affected, there would seem to be no great difference in the economic impact.

On the other hand, if for some reason or other we did not have at the time sufficient investment opportunities in this country, and unemployment was high, then the investment abroad would be in addition to investment at home and would give a positive stimulus to the American economy. Indeed, production might be stimulated enough so that the economy as a whole would be benefited, on balance, even if this foreign investment did not prove to be a financial success.

I believe that underlying many arguments in favor of foreign investment is the idea that the American economy cannot continue indefinitely to provide sufficient investment outlets for our savings—that sooner or later we shall approach investment stagnation and will need foreign investment to stimulate our economy.

What any of us believes regarding the need of this country for foreign investment depends to a considerable extent on his notion of the economic outlook for the next 10 or 25 years. Economists differ on this point.

Personally I am rather optimistic; I believe this country will not require substantial increases in foreign investment to keep it running on an even keel.

Our policy, however, should not overlook the possibility that this optimistic view may be wrong and that we may need increased foreign investment to maintain our prosperity.

We should not overlook another point. If foreign investment is made during a period of inflation in this country, it adds to the inflationary pressure and makes the situation more difficult to handle.

Now, leaving the question of the economic impact at the time investment is made, we come to the second question, namely, What is the economic effect on the United States when the investment gets to working in the country in which it is placed?

The investment in the usual case will help to build an industry—mining, petroleum, manufacturing, agricultural raw materials or what have you. This industrial growth or economic development will increase the income of that country. One result of the increase in the income of a country, generally speaking, is to enlarge its total demand not only for domestic products but also for foreign products. Of course, imports of some kinds of goods would decrease.

Statistics indicate pretty clearly that as a country develops economically and it has a higher and higher level of income, the proportion of income spent on imports goes down but the amount spent on imports goes up. Whether we would be able to take advantage of this increased demand and sell more goods to such countries would depend on whether we, in turn, made dollars available to them either by buying more from abroad or by expanding our foreign investment.

We cannot sell abroad more than we buy abroad except as we loan or give dollars. In the third place, we have to consider whether the profits on foreign investment are going to be returned to this country, and the capital is going to be repatriated and what the economic impact will be when that happens.

It is quite conceivable that our investors would be prepared to leave their profits and capital abroad for a very long time, in which case no foreign exchange problem is raised, but if they want to bring income back and capital back, then, the foreign exchange problem comes up; the problem of convertibility.

Shall we be buying more from the countries where the investments were made, or from other countries to which they sell, so that they can make available the dollars required in order that income and capital may be brought home? Such buying, of course, will give competition to our own industries, but bringing home income and capital will provide more purchasing power to buy more goods, so that for the economy as a whole the competition need not cut down domestic production and sales.

That is perhaps a somewhat difficult analysis to follow. The answer to your question, in summary, would seem to be that whether investment overseas is sufficient for the long-run growth of this country depends on how dynamic our economy is likely to be and that is a matter about which I, at least, do not know.

Overseas investment is sometimes urged to assure that our future raw-material needs will be met. I don't think it is a question of whether our investment is sufficient abroad but rather one of whether the raw-materials production is developed abroad, either through our investment and through someone else's investment.

Obviously we are going to need more raw materials in the future. Many of the underdeveloped countries, however, are not very happy about having foreign capital exploiting these materials, at least unless the foreign capital constitutes a minority interest in the operation.

Mr. Mills. Mr. Wender, would you comment on the matter from the point of view of my questions?

Mr. Wender. Well, I think I would rather pass at the moment if I could.

Mr. Mills. All right.

Mr. Collado, are you prepared to comment?

Mr. Collado. Well, I think that I won't try to cover all the ground that Professor Blough has covered.

I think I may try to interpret some of it a little differently.

Mr. Mills. Do you agree with what he has said?

Mr. Collado. I will try to indicate some possible differences.

I think first of all that one has to strike a suitable balance between the United States in a world economy and the United States as a relatively self-sufficient economic area.

Obviously, the United States is in a better position to look at itself as a relatively self-sufficient economic area than perhaps some other countries are.

On the other hand, I am sufficiently old fashioned to believe the more orthorox economic notions, that if you can increase the area of economic activity available to citizens of the United States, in trade and in foreign investment, that over time there will accrue net benefits to the United States as a whole, and the people of the United States, and I do not think I need to go through the usual economic arguments but I think with a larger general area in which to operate, with more investment opportunities, more trading opportunities, with more opportunity to take advantage of the existence in various parts of the world of the resources, both natural and human, I think it is clear that returns to the United States economy will be enhanced.

Now as to the manner, I think we perhaps have not said enough about the fact that if investors, the individuals, get a greater monetary return from the investment, that increases their purchasing power and if that can be translated into real terms by imports, in the ultimate analysis, then the economy benefits.

Now as to whether the volume of investment that has historically taken place, or is likely in the immediate future to take place, is best geared to that general purpose is a very difficult question.

I think most people feel that even if our national interest encompassed the economy of the United States in the narrowest sense, the maximum advantages of increasing world trade and of increasing the availability of foreign markets and foreign raw materials, can be achieved only by a rather sizable stepping up in the rate of economic development of some of the less-developed countries, that is, the rather sizable stepping up in the production in those countries of goods available to us for import of raw materials, and so forth, and also in the consumption in those countries of the goods we export.

Now, most people I think, would feel that the rate of foreign investment has been falling short of what would be economically desirable, and certainly, if I can go to the broader question that you have ruled out, whether it also encompasses our political or foreign policy objectives, I think clearly it has been felt by practically everybody that so far, unfortunately, private investment, while it has done a very considerable job, has not done everything that everybody would wish.

On that assumption I suppose you could say the rate of investment is not as large for all these reasons as we would in the national interest like to see it.

Mr. MILLS. Mr. Collado, I was not ruling out for purposes of our discussion, the subject matter of political advantages, and so forth. I was thinking, in the beginning, about pure economic realities and advantages. If this program must be based largely upon considerations other than economic growth at home, I would want to know that. It might be justified on grounds other than pure by those of economic growth here in the United States, and I do not say that it couldn't be so justified, but I was thinking in terms of whether we could justify the proposal in part on the grounds of desirability of economic growth here.

Mr. COLLADO. My feeling, I think I indicated, is that our political and broad policy objectives happily are married to the straight economic interests; that foreign investment does contribute to the en-

hancement of our economic situation at home; and that by broadening the range of activities, by increasing the level of economic activity abroad, and by enlarging foreign trade, investment, and income from investment there is a definite economic advantage at home, in addition to the broader national interests in the political sphere.

Mr. MILLS. Mr. Costelloe, will you comment, please, sir?

Mr. COSTELLOE. I would like to think of the importance of foreign activity to the domestic economy as not merely a matter of flow of goods, but also as a matter of flow of experience and technique.

In foreign countries problems are met sometimes before they are met in this country. I think we are familiar with the experience of England, which has often encountered problems about 20 years sooner than we encountered them here. England was in turn late in encountering problems, compared with the Germay of Bismarck. I would say that experience in utilization of the resources to which Mr. Collado referred is of great importance—how to use materials, how people can best order their lives with the problems they have, and how to solve problems which today are another man's or another country's, but tomorrow may be ours. I wouldn't underrate those factors at all.

Mr. MILLS. Now, let us go to the broader consideration, beyond the pure economic growth situation into the world political problem we face, and which would, of course, be affected, at least so it is stated by the proponents of a tax differential for foreign income.

I remember when the Secretary of the Treasury suggested the 14-point differential in connection with the revision of the code of 1954.

It was pointed out at that time that in the first year of the operation of such a differential that there would be a reduction in tax take to the Treasury of $147 million, which would indicate that in the first year of its operation, a tax differential would work almost exclusively to the benefit of existing investments overseas.

Now, what is the theory back of the suggestion for the 14-point differential that would require a reduction in the tax burdens of investments overseas at a time when tax burdens of investments in the United States cannot be reduced?

Mr. Blough, regardless of your own views on the matter would you give me information on that question?

Mr. BLOUGH. I was about to say you had better ask someone who believes in this.

Mr. MILLS. You, of course, are a student of it. Let me ask some of them that believe in it first.

Mr. BLOUGH. I might comment after they have.

Mr. MILLS. All right. Mr. Collado or Mr. Costelloe.

Mr. COLLADO. Do you want me to talk about the national interest justification or this first-year reaction?

Mr. MILLS. No. I am asking what is the justification from the point of view of what will happen in the first year. How do you justify the reaction that occurs in the first year from any point of view, of economic growth, national interest, world political situation, or what not?

Mr. COLLADO. I think the first question is one of statement of facts, of what revenue loss would be incurred if certain changes were made in the tax code.

It was my understanding——

Mr. MILLS. Pardon me, so you be clearly certain in what I am getting at. How can we justify a reduction in the tax burdens of foreign investment, when we cannot reduce the tax burdens of domestic investments?

Mr. COLLADO. Let me approach that in maybe three ways. First of all, I think the question of the total taxload in the United States is a very broad problem that has to be looked at in terms of the total revenue and total requirements. I think there is general agreement that at a suitable time, when revenue considerations permit, that there are a number of desirable adjustments to be made in the domestic situation, as well as in the foreign, so I don't think anybody is denying that something desirable should be done in the United States.

Now, with respect to the foreign, the justifications for doing anything to encourage foreign investment are a broad area in which I think there has been in the past substantial agreement. I am not talking particularly taxes now. I am talking about the whole area of encouraging foreign investment. I don't know that I really need to go further. I quoted briefly from the statements of the President on this subject. Clearly permitting, or encouraging, American capital on the one hand—and I think much more importantly, American technical and managerial know-how and initiative and all the rest of that sort of thing—to go to work in particular investments in foreign countries, would have a broad impact beyond the specific investments.

I don't want to dwell on this, but the National Planning Association has been putting out a series of studies—you may have seen some of them of the impact in particular South American countries of particular corporate investments. The one I am interested in and have just read concern the Creole Petroleum Co. in Venezuela.

The whole impact of that investment on the Venezuelan economy has gone way beyond the narrow limits of producing some oil out of the ground. The wise operation of the oil companies, plus the wise application of revenues derived from oil by the Venezuelan Government have revolutionized the economy of the country and they have made it now incidentally one of the largest export markets of the United States. You may have seen a study that was circulated a year ago, which shows benefits reaching down to manufacturers and exporters in every State of the Union and frankly every county of the Union.

The general impact of know-how and managerial impetus as well as the purely financial capital, I think, is pretty obvious. If it is desirable to encourage the development of foreign countries, for strictly economic or for these broader security and national-interest reasons, then investment is probably the best way to do it. I think we have been in the dilemma as a Nation of feeling that the developmental needs of foreign countries exceeded the rate private investment was doing the job, and that is why there have been all these attempts to have international banks, export-import banks, grant funds, SUNFED's, and all the rest of it, some of which the United States goes along with to a degree, and some of which the United States apparently does not go along with, and I think wisely because the attempt to do these jobs by intergovernmental finance and purely technical assistance doesn't bring to it a lot of the qualities of managerial know-how that the corporate investment brings automatically.

That is the great subject of private investment and private enterprise, and I think perhaps you don't want to dwell on that here.

Another subcommittee had hearings on that a few weeks ago, I understand. So much for that.

I think quite clearly that the results that you wish to obtain by private investment clearly warrant taking all appropriate steps to encourage it.

Now, I happen to believe that in the legislative field, in the field of direct, you might say, operation by the United States Government there is not too much that can be done to encourage private foreign investment, except in the tax field.

The attempts to create some sort of guaranties, which you mentioned earlier, have at best been of limited interest, apparently, to investors. The technical questions involved are very difficult and there are questions of policy and principle that I think make that whole approach of limited impact on the basic problem we are talking about. Much more important I think is what we call climate, whether a foreign investor encounters an economic situation in which he feels he can do business profitably, expand, and has a long-term future and can also bring some returns home to his holder share. Climate encompasses the whole question of balance of payments, convertibility and all the rest of it, as well as nationalism, local insistence in some cases on percentage of control as Mr. Blough mentioned, or other, should we say, situations that either make for a free local enterprise situation, or one that is highly controlled or restricted by the local government.

The climate is something that the United States Government certainly can contribute to and does through its entire program of international relationships, through the Embassies, through the constant contact, through, you might say, attempts to indicate the virtues of private enterprise system and of the foreign investment and foreign private enterprise system, and sound economics and all the rest of it, but that is something that you do over the years by constant contact and not something you do by announcing a new program.

Now, getting away from all that back to the tax factor, you do have a very real factor that influences the decisions of businessmen. Businessmen in the tax area look at individual investments and they look at them every day and help decide how much the return is going to be. Obviously taxes are an element in the return to the investor on his possible investment.

I can digress very briefly once more, and then I will stop digressing, I would like to make one point that everybody realizes, but perhaps passes over in their discussion, that investment does not consist of looking at a brand new country, or a brand new function, or a brand new operation, and determining to go forward and create a brand new investment and entity, put the money in, and so forth. Investment decisions of investors, and particularly of corporate investors take the form of what most of us are going through at this time of year, corporate capital budget reviews, in which managements of operations, at home and abroad, bring in innumerable projects—small projects, particular things, expansions, extensions. In our business, the fellow comes in and says I want to build a gasoline station at such and such a street corner. He doesn't say, "We want to create a new company in Zululand." The particular projects build up into large

totals. The volume of reinvestment abroad is also a very large figure.

Some of the statistics we looked at of the Commerce Department, if you look at the summaries and not the full reports, tend to hide that. We have what has been called a net, net of net investment in the numbers that show up on the surface but there is a very large amount of gross investment, and it is that gross investment that gives the impetus to foreign economic development. It is the sum total of all the investments and reinvestments, of all the particular operating capital projects that are put into effect, that really gives this drive to improve the economies of the foreign countries, which I gather is one of our purposes.

That number of $147 million, the revenue loss, certainly is, I think, in our national interest. We want increase in every possible way in the economic development and economic activity of these foreign countries, because we believe as a country that, skipping the usual questions of humanitarian and other impulses, but just on a straight business basis, countries that have a higher level of economic activity, whose populations are thus able to live at higher standards, are both from an economic point of view and from a military, security, and political point of view, better neighbors and friends in the world.

Mr. MILLS. How do you accomplish those objectives, Mr. Collado? This is what I am getting to. How do you accomplish those objectives of building the foreign economy which helps to strengthen our own economy, by permitting a reduction in the tax burdens attributable to profits derived from existing investments?

Mr. COLLADO. A number of the——

Mr. MILLS. You have already contributed to that growth?

Mr. COLLADO. The point I am trying to make—I might not have expressed myself well—is that a company in which you have made an investment initially, any one of your affiliated operations, anywhere in the world, during the course of any given business year, is operating, it is wasting its assets, it is depreciating them. If it is in the extracting industries, it is depleting its natural resources abroad.

Now, that company will constantly all during the year be considering new projects—we call them capital budgets, which are both renewals and extensions. If I can refer to my own company, because it is a little easier for me to talk in those terms and perhaps a little easier to understand because it is more concrete, take the Creole Co. in Venezuela which I mentioned earlier. They earned a lot of cash income from the sale in Venezuela and mostly from export from Venezuela of oil products around the world, mostly outside of the United States. They are expending funds currently in costs of production, they are also depreciating and depleting their physical plant. To some extent they are taking out oil—taking oil out of the ground.

Senator DOUGLAS. But you can write that off as an operating expense and it does not enter into the determination of net profits, does it?

Mr. COLLADO. Can I please go on, Senator, with this just a little further?

Senator DOUGLAS. Surely.

Mr. COLLADO. They are constantly during the course of that year determining how big an expansion in their facilities to carry on in the current, or the next future year. Some years you may actually

have a cash outflow from that enterprise. In other years, it may well be that the need of building new refineries, or new terminal facilities, or new developments in this so-called gas injection or any of those other systems which are very costly, will actually require that funds be put back in.

Now, when you examine into the economics of any one of your expansion projects, you look at all the factors affecting your profits, and the net tax system is clearly one of the elements that you take into account.

Now, in many of these foreign countries, they are desirous of expanding, and they have tax systems with rates that are actually considerably lower than those in the United States. Moreover, many of them give tax incentives of one kind or another, such as investment allowances, accelerated depreciation, and many other kinds of things, in order to encourage the investors to take action there.

One point I want to make is that this is a continuous flow. It isn't an investment that you made today, and it goes on forever. You make a new decision every few days. Each investment is constantly being renewed. You are constantly reinvesting and each of those decisions has the same tax and other factors to be considered that the original investment had. I am trying to distinguish between the idea of a permanent existing investment of some nebulous overall nature and the fact that each current decision taken by the managers of an existing investment is exactly the same as the decision to be taken by somebody who is thinking of going into a brand new field that he was never in before.

The second thing I would like to emphasize has been pointed out by the Secretary of the Treasury. There was a lot of discussion of it at the Rio economic meeting a year ago. The United States system may completely negate the incentives that the local countries attempt to put into their legislation to induce investment there. That I think you are familiar with. You can discuss detail of that, if you wish.

Mr. Mills. I still come back to my question. Take everything you say as being absolutely true, that the thesis, or the theory back of the proposal in 1954, when taxes at home could not be reduced, was that there was such a compelling desire for us to enter the field of helping to rebuild economies throughout the world, in backward countries and otherwise, that we would induce, by tax stimulation, investments of private capital from here in those areas. Now, if that is the theory of it, and I assume it would have to be the theory of it, then how is that accomplished by reducing the tax take from profits derived from existing operations, in countries of Europe that are not underdeveloped, say, which are already there, contributing to economic growth in those countries? I haven't been able to understand how the Congress could have been expected to justify a reduction in the tax burden presently placed upon foreign investments to the extent of $147 million, when we were cautioned that we could not reduce the tax burden upon corporations operating here in the United States. I haven't been able to understand how the theory of this thing can be justified to that extent.

Mr. Collado. Your question would raise in me about 6 or 7 lines of response because it is a very broad question. In the first place, I think that this figure of $147 million is very near the estimated total tax take today from foreign income.

Mr. MILLS. No. That was the Treasury's estimate of the loss in revenue through only the 14-point reduction.

Mr. COLLADO. It is also, however, very close to the figure they have estimated as being the total foreign income from this sort of investment we are talking about. The figures that have been used will range between $150 million and $200 million.

Mr. MILLS. It has developed that the figures used by the Treasury in connection with our amendments to the code in 1954 were very conservative in many other instances.

Mr. COLLADO. I would have no basis on which to question the estimates of the Treasury, because I haven't any access to the records on which these estimates were made, so I don't think I can help you very much on numbers.

It is true, however, that they were expecting the 14 points would go a long ways toward eliminating, if it were put across the board broadly, without a number of other kinds of limitations on its impact, the total income tax, income of the United States from investment income abroad.

Let's not go into the facts. I think on the basis of the bill the tax costs would be less because it is hedged around with restrictions, but I don't think we can settle that.

It seems to me that there is one question that you have to point out in any event, that one of the effects of the United States tax system, which the Secretary of the Treasury himself recognized is in a number of cases and particularly in cases which involve quite a lot of the total revenue because they involve quite a large percentage of the total investment abroad, the tendency of foreign countries to raise their tax rates because it doesn't cost anything investmentwise, since it is merely coming out of the United States Treasury—in other words, the total tax impact on the company isn't going to be much changed so the foreign government feel, "It is our country in which they are making these earnings, we will take the total taxes." That is a very real tendency that I think has been recognized over the years. Certainly Secretary Humphrey has referred to it a number of times. If that is the case, we may lose this revenue anyway regardless of legislation. That is one point.

Secondly, I think we have got to look also into the total volume of foreign investment, the attraction to American investors and the fact that investors in general are expecting to bring dividends home—which dividends in turn are paid out to the shareholders and are taxed in the United States, so that what you give up in the corporate taxation, you by no means lose to the revenue, because ultimately I think you will increase the rate of dividends to American shareholders and that is taxable at surtax brackets, and so forth, perhaps even at considerably higher rates. Those are questions that relate to the revenue.

You mentioned European countries in which perhaps the situation is a little different than it may have been in certain South American or Asian or African countries. The fact of the matter is that a number of the more industrialized countries are first of all with higher tax-rate regimes than some of the countries more actively encouraging foreign investment. If that is the case, the revenue take from those countries is already very small, because of the operation of the foreign tax system.

Then there is the question from the national interest point of view, whether in fact we are interested in foreign investment to develop economies, even of those countries. After all, the entire Marshall plan was directed in large measure, at least, to the rehabilitation and expansion in Europe and a lot of people feel that is our first line of defense, and investments there to build up their economy have certainly been encouraged by the administration. Certainly there was encouragement in places like Italy and France, so I don't think there is that geographical distinction. I am taking a lot of time with your question.

Mr. MILLS. Let's leave that point, if we may, and let me ask this question: You injected into the record the operation of the Standard Oil Company of New Jersey in Venezuela. You operate, I presume, through a subsidiary corporation owned by the Standard Oil Company of New Jersey, known as the Creole Oil Co.; is that correct?

Mr. COLLADO. Yes, sir.

Mr. MILLS. Let's take that case now, because you do have a 14-point differential in your tax rate at the present time, because of the Western Hemisphere treatment.

Let's see whether or not in present operations in the Western Hemisphere we see any of the characteristics of inducement to investors with American moneys to come in, to help rebuild these countries.

The Standard Oil Company of New Jersey owns all of the stock of the Creole Oil Co.?

Mr. COLLADO. We own approximately 95 percent.

Mr. MILLS. Is any of the 5 percent owned by stockholders in the United States?

Mr. COLLADO. Yes. Creole stock is traded on the American Stock Exchange and it is a very attractive stock.

Mr. MILLS. But that would be a small part, so I think for purposes of this discussion, it would be legitimate to say that it is not an investment in the Creole Oil Co., that may occur by the American investor, but an investment in the stock of the Standard Oil Company of New Jersey, which in turn owns 95 percent of the Creole Oil Co.

Now, what I am getting at is this: Is this the normal procedure through which an American corporation operates in a foreign country, namely: Does the American company have a plant in the foreign country, or does the American corporation have a subsidiary operation that has a plant in a foreign country? It makes a tremendous difference in my thinking as to whether or not a tax stimulus or a tax differential of this sort would encourage the investment of American capital for the purpose of foreign use. If a subsidiary type of operation is the common practice, the subsidiary's profits will come to the United States corporation, be comingled with profits from domestic operation and then divided in dividends to the stockholders of the parent company, so that the stockholder of the Standard Oil Co. is concerned not just with the operations of the Creole Oil Co., but with the operations of the entire Standard Oil Company of New Jersey.

I, as an investor, would make a decision to buy stock in Standard Oil Co., not because of any particular tax differential enjoyed by a subsidiary, but because of the overall values that are attached to prospects for profits that might accrue from the stock of the Standard Oil Company of New Jersey.

Mr. COLLADO. That again is a broad area of questions, Mr. Chairman.

I think first with respect to the early question that you posed, the form of foreign investments is varied; all of the types that you mentioned are employed, and in varying degree and very frequently by the same group of companies or system of companies. Certainly there are individual companies in which the entire or virtually the entire operation is limited to operating in a particular foreign country in a particular phase of activity and still its American shares are held by American shareholders.

There are other cases where American shareholders actually purchase directly the share of foreign incorporated companies.

Mr. MILLS. But to the extent that this is a subsidiary operation, am I right in the possibility that a tax stimulus of this sort would offer no actual encouragement for American capital to be invested in a foreign operation? American capital will be invested in the domestic corporation which might have a subsidiary operation; but not as a primary purpose.

Mr. COLLADO. Actually, I think that we might just as well go back to talking about the Standard Oil Co., because I think that is what you are referring to.

Mr. MILLS. I don't do it because I have any grievance with the Standard Oil Co. at all, but just merely because you injected the Creole Oil Co. and I wanted to get some information if I could on that.

Mr. COLLADO. On the New Jersey company, our form of organization is not exactly that of many other companies. Many companies operate with a United States parent that has a direct plan of operations abroad, as well as various subsidiary corporate operations abroad.

In our own case, we do not operate with branches abroad. We operate solely through holding of interests, either a hundred percent, or majority controls, or in some cases minority positions, in other corporations, which are either American corporations which operate abroad, or in many cases are foreign corporations, which operate in the particular areas, so we actually pretty well go across the board on this thing.

Your question is, How do you encourage people to be interested in Jersey shares, in investment in Jersey, by doing something that has to do with increasing the attraction of investment in the foreign country?

Mr. MILLS. A subsidiary operation.

Mr. COLLADO. I think the only way I can answer that is that in the first place, historically it is clear in recent years, the whole trend is that American foreign investment in the private sector is taking its place through corporate investment, and it is the American corporation that is making the foreign investment, rather than initially the separate decision of the individual American shareholders, so that the big flow of investment is the very type we are talking about, and the fact that corporations are induced to invest abroad and management of the corporations and ultimately the shareholders, who elect the boards of directors and approve their actions, and so forth, approve of the investment, that is the place where the tax law has its impact today by and large.

Managements make the decisions, boards of directors ratify them, and shareholders in their annual meetings and other respects you might say confirm those decisions. That is the way you get the investment.

Now, with respect to whether an American shareholder thinks well of the foreign investments, and is induced to be a happy shareholder, if you want to call it that, and be interested in being a shareholder, that, I suppose, flows from his analysis of the entire return which he gets on his investment—the dividends he receives on his shares and not only the current dividend, but his estimation whether the prospects for the particular company in the future are good, whether he thinks that the type of decisions that its management, the board of directors, had taken are good.

In a company such as our own, which last year received 73 percent of its consolidated net earnings from foreign corporations, presumably the shareholders, who, I hope, think well of the management, must understand that there is a very large amount of foreign trade and foreign investing going on. I think that is where they make their decision, but in a sense they are approving the decisions which the management is making which are the investing decision as far as the immediate specific foreign investments are concerned.

Mr. MILLS. I think the officials of the Standard Oil Company of New Jersey are to be congratulated because it is my understanding that the stocks of the Standard Oil Company of New Jersey are considered to be in the blue-chip category anyway, so I do think you are to be congratulated and since it has been so profitable for you to operate in foreign areas, to the extent of 73 percent of your gross take coming from those areas, you have done such a remarkable job under existing tax laws, I question the advisability of altering it or offering inducement to anybody else.

Mr. COLLADO. I expected that question, so I am not too surprised. I think I don't want—I don't think we want to get into a very detailed analysis of the kind that the Society of Security Analysts go in for. I don't think this committee wants to get into that. I think the answer is that a company, such as my own, enjoys a very good performance record; we think that is good; we think it is very good in our industry; and we think it is good in terms of American industry in general. However, our total income in terms of capital invested, net worth, and all the rest of it, is not out of the range of the general United States industry.

We think we are well up. We think we are competitively very good. We take certain pride in that, but we don't think that is a very big differential. Moreover, our foreign operations, examined individually, do not show a notably greater rate of return than our domestic operations, so it isn't purely some bonanza from abroad. We are getting what we think is a good average return, which we try to improve from year to year by more efficient methods, mostly involving very heavy investment. That is how you improve your efficiency.

Mr. MILLS. Let me say before I pass on, Mr. Collado, that I am not minimizing the acumen of the executives of the Radio Corporation of America either. I think they have done an outstanding job, and I think that they have been able to profit from investments overseas as well—perhaps not to the great extent of the Standard Oil Company of New Jersey, but certainly to a sufficient degree that the stock of the

Radio Corporation of America is not to be frowned upon. I don't want to make you feel that I am just picking out the Standard Oil Company of New Jersey to praise, but I think both of the United States companies have been well managed and that you have done an excellent job, in spite of all of the deterrents which exist presently in tax law and you are to be commended then for the job that you have done.

I mean that in all sincerity and in all fairness. Frankly, I wonder sometimes, as I view the tax law, just how there could have been as much growth accomplished in the United States since World War II, and so much done by business and labor, by everyone, to maintain this high degree of national product, with the Federal Government finding it necessary to take as much as it has from the individual and from business.

Now, I want to turn to another aspect of this whole problem, and that is, let me put it this way: We would naturally have to be interested in determining tax policy to see that it encourages balanced growth. If you provide for a differential in one area, I think, Mr. Blough and others are right when they say that there must be a pretty strong justification or showing for that because when you provide a differential in one area, it tends to become a preference for economic growth if we are not careful.

In viewing this matter of the 14-point differential on income derived from investments overseas, what is the effect of such a proposal on small and new business, and the possibility of growth here in the United States by small and new business? Are they placed in a discriminatory position? And the reason I ask the question is this: It has been called to our attention during the course of some of the hearings we have had, or considerations at least that we have had, in the Ways and Means Committee with respect to the 14-point differential for Western Hemisphere corporations, that there is a decided discrimination against American corporations who desire to export American-made goods into the areas where these branches or subsidiaries of American corporations can operate, due primarily to the differential that now exists in tax.

For example, a company in St. Louis may manufacture shoes and desire to sell those shoes in Brazil. Another American corporation may have a branch operating in Brazil, or a subsidiary operating in Brazil, manufacturing shoes.

Now, these people that I have talked to tell me that they find it increasingly difficult to sell American-made shoes in competition with shoes made by that American branch, or American subsidiary in this foreign country.

If we continue this differential in tax treatment beyond the Western Hemisphere for the rest of the world, are we promoting, therefore, balanced economic growth in the United States, or are we creating a situation in which small and new businesses might find it more difficult to grow in the United States?

Mr. Blough, would you take that up, please, sir?

Mr. Blough. Mr. Chairman, this opens up a very interesting aspect of this whole subject, namely, what is the effect of economic development in the less developed countries on American industry, and what are the determinants of exports from the United States.

I think the determinants of the total amount of exports from the United States are the amounts we are willing to import, plus the

amounts of net investment abroad, and plus also the amounts we are willing to give away. Perhaps I shouldn't, use the term "give away," because——

Mr. MILLS. It has been used here in Congress.

Mr. BLOUGH. I am not using it in a derogatory sense.

The American exporter is not only the small manufacturer, he is not only the large manufacturer, he is the farmer, he is the producer of any kind of goods which does not have its sole market in the United States.

Now, the total amount that all of these producers put together are going to be able to sell abroad is limited by the dollar exchange available to other countries and the available dollar exchange is limited by the factors which I have mentioned. What has happened in many cases is that American manufacturers had no desire to set up plants abroad, but found that the market was drying up for their export products. I have asked a considerable number of businessmen over the past 6 months why they had set up business abroad. The answer usually was something like this, "We had been exporting goods abroad. We found that we were not able to expand our exports. The currency situation became difficult, we couldn't sell. The hostility within the country to things being produced outside the country and shipped in became more and more noticeable. If we were going to exploit the foreign market, it was necessary for us to go abroad and set up an operation in order to take advantage of that market."

I think you will find—and I think Mr. Wender's study shows—that a great deal of the investment that has gone abroad has gone abroad for those reasons.

Now, when a business in the United States does go abroad to produce there may well be an impact on the exports of the other manufacturers in the United States. Your point is well taken. There undoubtedly are many specific cases of small manufacturers, and big ones, too, whose exports abroad run into this kind of competition.

I would like to point out that producing abroad does not reduce the total exports from the United States, including agricultural exports, manufactured exports, and mineral exports. The total of all kinds of exports, as I have previously noted, is determined by the foreign exchange situation, and that is determined on what we are willing to buy and how much foreign investment is going abroad. An expansion of foreign investment actually increases the markets for American exports during the time the investment is being made.

When an underdeveloped country develops, whatever the source of its capital, there is a shift in its imports. It reduces some kind of imports. It increases other kinds of imports. The kind of imports it usually reduces first are such things as textiles. It may reduce imports of shoes, and of other staple consumer goods. The kind of imports it increases are machinery and kinds of consumer goods which cannot be produced efficiently within the country, such as automobiles, style goods, and luxury items. Unquestionably the economic development of underdeveloped countries, and this development will continue more or less rapidly whether through domestic savings or through our investment abroad or through somebody else's investment abroad—is going to shift the demand for different American products.

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The British found this out. I noticed in a recent newspaper account, that Lancashire has been almost completely transformed from textile production to engineering production—machinery and hard goods—and it was a necessary adjustment.

There is no question in my mind that adjustments will be necessary here also as economic development takes place in other countries. Exports of some goods from the United States will likely expand in some directions, and later contract while other exports then expand. But I keep coming back to the point that the total volume of our exports is determined not by how hard we try to push our manufactured products with short-term loans, tax incentives to exporters, and so forth, but by how much we are willing to buy from abroad, and how much we are willing to invest abroad. Those are the determinants, not of how much Mr. A or Mr. B can sell abroad, but how much everybody in toto can sell abroad. That is the reason I have indicated both in my material in the published volume, and in today's statement, that tax incentives on profits from exports as such are bound to be futile from the viewpoint of the economy as a whole, because we can't increase the total volume of exports in that manner. We can increase the volume of some exports in that manner, but not of all exports, and what we add to one we deduct from another. If we had a deficit balance of payments and a shortage of monetary and foreign-exchange reserves so that our purchases from abroad were being limited by our inability to sell abroad, the answer would be different. But we are not in that situation at all.

I would like to make one comment on the material which was presented previously by Mr. Collado, with much of which I am in agreement. In answering your question, he did not use the argument that the present tax provisions are unfair to American investors abroad. He spoke rather of incentives to investment. I think it is very important that the committee and the Congress and the public distinguish clearly between the question of what is fair, and the question of whether tax concessions should be made, regardless of what is fair, in an effort to stimulate private foreign investment. Many people have said that our present laws are unfair to foreign investment, that we shouldn't tax income from abroad at as high rates as we tax domestic income. If, however, everyone were willing to accept the principle that it is fair to tax income from business abroad as high as income from domestic business, there would be a great advance in the level of discussion, since attention could be concentrated on the incentive question and on features of the law that are believed to cause specific inequities.

Mr. Mills. Mr. Wender, I have been somewhat confused about some trends that are taking place. I assume that what we would like to do under this program of which the 14-point differential is suggested as a part would be to obtain such help from private American capital as is needed to assist in building in many of the foreign countries, if not all of the foreign countries, the type of economic growth that we have permitted, or that we have attained in Venezuela where exports from the United States now presently amount to some $800 million a year.

Certainly that development has been in the interest of economic growth here at home.

We didn't think too much about what we were doing when we were permitting the application of depletion allowances to oil discoveries in Venezuela, outside the boundaries of the United States; when we provided the 14-point differential in tax treatment for American corporations operating in the Western Hemisphere. We were doing in that instance what I take it the President suggests we should do throughout the world, so that I would say that that was in our national interest, what developed there, if it is in our national interest that that kind of development take place in other underdeveloped areas of the world. After all that is accomplished, we are then faced with a decision that the product of that investment, which has occurred, must find its market outside the United States, because it appears to be contrary to the national interest for that product to find more than a very small percent of its market here in the United States.

Are the two positions which are now in operation consistent, Mr. Wender?

Mr. WENDER. Well, Mr. Chairman——

Mr. MILLS. Can we actually obtain economic growth that we want in these foreign countries and which the 14-point differential is intended to accomplish without permitting the product of that growth to have access to markets here as well as elsewhere?

Mr. WENDER. Well, can I go back to something? I think it relates back to Mr. Collado's justification to some extent for a differential tax treatment, part of the same problem, and I would just like to throw out what seems to me to be questions that cast some doubt on how effective any tax plan is really going to be.

First of all, you have got most of Western Europe and much of the British Empire, where your tax rates are such that a 38-percent rate really means very little. Whether you have 38 or 52 in this country, the rates are very close, so that the area in which you can have an effective incentive is automatically limited to Latin America and Africa, and parts of Asia.

To build up those countries, usually you think in terms of the need for roads, the need for powerplants, the need for steel mills or at least iron mills (however you turn ore into iron and eventually steel), and these are just the areas in which the United States private investment has been very reluctant to go. For example, I think there is no steel mill abroad owned by an American corporation. There are very few cement plants.

Mr. MILLS. Just on that point, we do have a steel mill in Brazil. It was financed with American capital, at least loaned through the Export-Import Bank. I remember it is $35 million.

Mr. WENDER. I was talking about private companies, not about Government. That is part of my point. I want to get at what seems to me to be a most important distinction here. I don't think we can count on private investment—no matter what we were to do, even if we were to give them a bonus for investment abroad—to do all of the things we want ultimately to be done in some of these foreign countries. I may be wrong. I concede that. But I think there is a real question there whether we will ever do that kind of thing.

Mr. MILLS. In other words, it is your thought that it takes more than merely a tax stimulus to get investments into a certain country?

Mr. WENDER. It takes more than that.

Mr. MILLS. For certain purposes?

Mr. WENDER. Yes. I think for the basic things you need to start out with it is very, very hard to get capital. It is easy to get the capital for producing aspirin in a foreign country. I am not trying to cast aspersions on production of aspirin, but if you can bring in tabulating machines, which are not very expensive, people will take risks on that type of machinery. As a result, there is a lot of light industrial development and that, I am sure, will continue. I don't think you will ever get people, and by "ever" I mean within the foreseeable future, to invest $25 million or $100 million in the utility plant abroad. That is, a private company.

Secondly, I think there is a question of how effective tax incentives actually are. We have had an incentive of a 38-percent rate in the Western Hemisphere, and interestingly enough, most of the manufacturing in the Western Hemisphere has not chosen to use the Western Hemisphere trading provision but instead has organized itself in subsidiary form. Creole is the major exception, and very successful, of course, but I suspect that had something to do with the oil that was available in the ground rather than the Western Hemisphere trade-corporation provisions.

Mr. COLLADO. Both probably, to some extent.

Mr. WENDER. In terms of this investment also, Mr. Collado spoke of the fact that every day there is an investment decision, but some of those investment decisions I think you have to recognize are automatic. It is like, for want of a nail a kingdom was lost. If you have a big investment and you need a piece of machinery to keep it operating, you are going to invest in that piece of machinery. You have got to because you have got a lot at stake.

So it is in the area of the nonautomatic decisions, the decisions to do something you haven't done before, that your taxes can have an effect, and there I think it is hard to judge whether they will have an effect. I think there is doubt that it will be very effective, because of the many problems you face. If you are going to go into a new activity you don't know what your costs are going to be. You have many other questions. You don't know the full extent of your market. You know it to some extent or you probably wouldn't make the investment, but you can't get down to a very fine point such as that an additional thousand dollars will each year earn $500, and if you pay a 50-percent tax you will end up with proportionately less. I don't think this occurs in most management decisions. I don't think that such calculations are of very great weight because the business uncertainties are much larger and much more important.

Finally, if I may for a minute, going back to what Professor Blough answered, I think in this area we also should keep in mind that we are talking largely about big corporations, not small. Most of American investment abroad is made by very large corporations. There are naturally limits on the amounts small corporations can invest. There are capital limits. I think more important, there are management limits. Small firms have the problem usually of getting management and keeping management, and they don't have the management to send abroad.

Mr. MILLS. I have taken more time, Senator Douglas, than I intended. I would like to recognize you to interrogate.

Senator DOUGLAS. Have you finished?

Mr. MILLS. I haven't, but go ahead. Senator Douglas will interrogate.

Senator DOUGLAS. The first question I should like to raise is, why is it economically desirable to give tax preferential treatment to corporate income from outside the United States as compared to corporate income within the United States. Would we not get from an economic standpoint an even more efficient allocation of resources by placing the burden on comparative-profit rates? Let me throw that out as a question and then let me develop it.

There are great economic inducements for investment in so-called backward countries. In the first place, the ratio of capital to natural resources is low and hence the productivity of capital is high. This is certainly true in connection with the oil of the Arabian Peninsula. I have not talked to people in Arabia, but I have talked with people who have been on the peninsula and certainly there is an amazing readily available, more easily available supply of oil so that investment of capital there would mean a low production cost per unit, and a very high-profit rate.

Similarly, in so-called backward countries, the ratio of capital to labor is low, and hence productivity of capital is high.

When one adds to this the fact that these countries have a low-wage structure, and if we can transfer modern technology to the degree that we know modern technology can be transferred and have the machinery operated by labor receiving a lower hourly wage rate, it would mean that production costs will be lower in money terms as well as in human terms, and in the world market because of the interconnection of prices, the rates of return would be high.

In other words, there are these economic incentives to influence the flow of capital all over the world. During the period prior to the First World War, this was the method by which British capital went over the world and it was very profitable to the investors in Great Britain, aside from political upheavals which from time to time swept away the principal. The query I would like to raise is this: Why should we have a tax preferential treatment or a tax preferential stimulus for investment overseas? Why not let this be settled by the normal processes of profit margins?

Mr. Blough, would you reply to that?

Mr. BLOUGH. Senator Douglas, as I indicated before, in general I take a negative view of preferential tax treatment because I think when the United States looks at the investment of its people, with respect to the effects of taxes on the allocation of that investment, it is the comparative tax burden on the investment inside the country, and on investment outside the country that is significant. Now, of course, many people have taken a different position, arguing that taxes on foreign investment should be lower because risks are greater in the other countries; and also that United States taxes on income from business abroad should be reduced to the levels paid by competing corporations of certain other countries; and again, that expenditures by the United States Government are not as important in the production of income abroad as of income at home.

I think these arguments should be developed by people to whom they appeal more than they do to me. As of now, my feeling is that with respect to fairness and to neutrality in the allocation of the resources of the United States, the present general theory of the Federal law is

sound, namely, that the tax rates should be the same for income whether deprived abroad or at home. Incentives are another matter; there we are trying to shift resources. If you are trying to get capital to go abroad—I doubt whether the tax differential will do it—but at any rate, you have a justification for such a differential.

Senator DOUGLAS. But there is special exception made in the case of Latin America and there is exception, as I understand it, made in the deferral of taxes on reinvested earnings of foreign incorporated subsidiaries of American concerns, am I correct?

Mr. BLOUGH. That is correct.

Senator DOUGLAS. My inquiry is, was it wise to get started down this road in the first place?

Mr. BLOUGH. Well, I was in the Treasury at the time that the 14 percentage points was first put in, and my recollection is that there were a very few specific corporations which had particular financial problems, and which were represented by some pretty influential people, and Congress——

Senator DOUGLAS. This is not an economic argument. It may be a political argument, but it is not an economic argument. We are trying to be economists and statesmen, and not politicians, you see.

Mr. BLOUGH. Yes, indeed, and to conclude my point, it seems to me that the considerations which dictated that action were different from the ones you have in mind.

Now, the matter has been rationalized since then into something different, but if my memory serves me correctly, that was the actual basis for it in the first place.

Senator DOUGLAS. Mr. Blough, you are very careful not to make a definite reply to my inquiry. I take it that you hold to the belief that we should trust to comparative profit margins to determine the allocation of capital as between countries, rather than trying to stimulate the flow in a given direction by preferential tax rate.

Mr. BLOUGH. I am inclined to think that from the viewpoint of the whole future picture of the United States, political, security, and economic, that we would be benefited by a more rapid increase in investment abroad, but——

Senator DOUGLAS. Is that a political consideration or an economic consideration?

Mr. BLOUGH. That is largely a political consideration.

Senator DOUGLAS. It may well be true.

Mr. BLOUGH. I think investment abroad is not economically harmful to the United States and, indeed, is beneficial to it; but if we were speaking only of the United States economic interest as completely disassociated from the political importance of the development of underdeveloped countries, I would not see the justification for specially pushing investment abroad.

Senator DOUGLAS. That is the point I was trying to make. I further want to point out that I was not implying that we should not have private investment abroad.

Far from it. I was merely saying, why can we not let the forces of the market determine the amount of private investment which we would have? Mr. Collado?

Mr. COLLADO. I gather that some of these questions perhaps are addressed to me, and Mr. Costelloe.

Senator DOUGLAS. Not unless you wish to reply to them.

Mr. COLLADO. I would like to, because there have been a number of points that I didn't cover or didn't make clear earlier in further questions.

I think in the first instance that I should like to say just a very few words about the economics of production abroad, and operation abroad. It was different 20 or 30 years ago, but the extent to which today some of these foreign operations are so much more profitable, or the foreign costs are so much lower, is greatly exaggerated.

As a matter of fact, in the Middle East oil properties some of the initial investments were very satisfactory. To expand production in that area today is taking a very heavy amount of capital investment, and I think that any disparities are being corrected.

Now, secondly, I happened to note in our own case, and I think this is true generally that there are other parts of the world in which the net return per barrel of oil production is considerably greater than in the Middle East. The Middle East has a great transportation disadvantage as compared to most markets.

As to the further question as to comparative wages, I grant you that in many parts of the world wage rates are below the United States standard, and I think the real income of the United States is one of the things we are most proud of.

We want to maintain and increase it.

It is also however coming up fast in most of these foreign countries. Secondly, for a number of reasons, productivity in many of these countries is not per capita at all up to the United States standards, so you have to take that into account.

Finally, I keep referring back to Venezuela, which is unfortunate, but wage rates for comparable jobs in the petroleum industry in Venezuela are higher than in the United States so that particular argument doesn't apply to this one particular case.

With all of that, I think that the market factors do apply in very considerable measure.

Going back to the justifications, it is true that in the series of questions which the chairman had put to me, I was attempting to argue the national interest case, because his question was that. That is by no means the only argument though that has been advanced either by myself or by others for the series of tax proposals that have been made. They do encompass fairness or equity in terms of this whole question that I think we have all agreed on, the peculiarities of the system whereby the corporate form makes a great deal of difference in the tax regime.

In other words, I think all of us have agreed that there is no economic reason why corporate form, which arises from other circumstances, should affect the tax regime.

Certainly, questions of equity and fairness come into that area. As I said earlier, and as expounded in the papers of all the members of the panel in the compendium, there are a number of areas in which foreign corporations actually have less favorable tax treatment than American ones.

You have referred to depletion if you use a foreign corporation. That is not the only one by any means. There are all of these percentage investment requirements—50 percent and a number of others. Finally, there is the whole application of the tax credit system. It is

by no means uniform. Foreign tax systems frequently don't have income taxes that qualify under the United States concept of an income tax, and while you may be very heavily taxed abroad you don't fit into the exact definitions of the United States regime, and some elements of double taxation come in.

I think all those things can stand on their own merits, without regard to this, you might say, political and national interest justification for expanding foreign investment, and in the earlier parts of my recommendatory paper, we took up six different proposals that I would consider all in that category and which I think are all very important.

Now, these arguments which do relate to the 14 points are also, I thing, a little broader than merely national interest and increasing foreign investment.

There are differences. There is certainly a well developed body of opinion that taxation at source has great justifications, and we really have gone a long way toward recognizing that in the whole foreign tax credit regime.

Actually, if you did not have the credit against foreign taxes, many operations would find themselves with 75 and 80 percent effective tax rates, and, in fact, in our own case, because of the anomalies and quirks of the foreign-credit regulation, we have, I hope, usually for short periods of time, found that particular operations did enjoy the doubtful advantage of 80-percent tax.

That is because of the difficulties of reconciling the form of the foreign tax with the regulation on foreign-tax credit, and, obviously, an economic operation isn't going to stand an 80-percent tax for a very long time. It is certainly not going to develop and expand.

Some of those situations have been recognized, and can be further cured, but the existence of these things has suggested to many people, including as you know the National Foreign Trade Council, that the preferable regime would be to have no United States taxation whatever on foreign investment.

Well, there is a whole series of arguments there that I don't think I will attempt to go into today, and I think that the 14 points can be justified on a number of arguments that relate to 14 points.

I suspect though, that the choice of 14 points is partly convenient, partly precedent of Western Hemisphere trade corporation and partly, if I can be very frank, a feeling that it will do most of what a complete absence of taxation would do, and still be less difficult, perhaps, to explain, and to put it crudely, to sell.

Now, there is in my opinion, no question that all these arguments about risks of foreign investment are real. We know there are risks in foreign investments. There are all kinds of risks and they are superimposed on the kind of risks of domestic investment.

There is another area of theory that relates to the fact that the United States Government affords investors in the United States, and affords American citizens and taxpayers a great variety of services and protections and benefits at home which it is not in a position to afford them on their foreign investing operations. And that in itself is judged by some as a reason why the income from abroad should be taxed at a lower rate. All of those things I think are quite in addition to the direct arguments on the 14 points which I tried to summarize in my opening talk—these competitive situations, these

area competitive situations, the fact that foreign investors, foreign in the sense of having foreign origins, other types of British, Dutch, Canadians, Belgians, or some other foreign investors may have advantages that ours do not have, and then finally these national-interest arguments which we have talked about at great length.

So I would like to think that I was arguing on the basis of the broad group of questions, and not merely the national-interest one, and I don't think, Professor Blough, that I have thrown over these other justifications. I was only concentrating on the question that the chairman had asked me.

Senator DOUGLAS. Would either Mr. Costelloe or Mr. Wender like to make a brief comment on this query?

Mr. COSTELLOE. I would like to make a point which Mr. Collado has made in a slightly different way, that I think at a minimum foreign business should not be discriminated against. I think the present regime does that in fact. It can be said that the Western Hemisphere trade corporation is highly advantageous. It so happened that our own company has not used it. Many comparable companies have not used it for sales abroad, for the simple reason that its highly complex and very rigid qualification tests frequently are not suitable for the efficient conduct of business. That is important. The efficient operation of a business is the first criterion. A business must make money and then you worry about taxes. In a sense, I am saying in a different way what Mr. Wender said, but more. I am saying that the present regime with its pitfalls, imposes an undesirable set of tax and other risks on business management. In most companies, foreign enterprise must compete with domestic enterprise for capital and personnel.

What are the risks, for example? If you have a foreign corporation, the chances are, even in the case of a company as large as Mr. Mr. Collado's, that foreign participation by minority interests may be necessary. That may mean that you cannot get an ordinary loss on worthlessness of the company. You must own 95 percent of the company to get an ordinary loss when it becomes worthless.

In the domestic field you can set up the operation as a branch. Thus, in the foreign field, you have an additional element of tax risk.

If you do get your foreign company established, and if its successful, the chances are that the foreign country will soon exert pressure to have you increase its capital by means of a stock dividend, which may incur tax in the foreign country but not in the United States, so that in that year you will have a large amount of foreign tax—far more than you can utilize against United States tax under the present limits. There is now no provision for carryover of unused foreign-tax credits. The result is that under the present system you will lose the credit and pay a combined rate higher than the rate that would apply to domestic earnings.

There are many imperfections of this sort which I think do unduly impede the embarkation of American talent and American capital in foreign ventures. I think that they might often outweigh any 14-point differential, as I have indicated has occurred in the somewhat different case of the Western Hemisphere trade corporation.

I think that in the foreign field we owe it to ourselves to be a little bit more adventurous than most of this discussion has been. When Columbus went to Isabella he didn't have too many rational arguments. He said, "I think there is something over there; can I go

there?" Isabella said "Yes," and she prevailed although Ferdinand frequently said "No." After three trips to the New World, Columbus still didn't know where he had been. He had been there, and that was a good thing. And no one can doubt now that it is.

In this field today I would like to see less of a stately parade of economic concepts derived largely from academic learning, and more of a spirit of adventure. I think you find that spirit in business, and I think that activity like today's will help people to understand better the experiences and problems on both sides. If we can keep it up, I am sure we will make progress.

I certainly hope we do because I think this matter has importance far beyond the commercial or fiscal. I think in a real sense is vital to the paramount interest in honorable peace.

Mr. WENDER. I wanted to support to some extent what Mr. Costelloe said. I am not sure that anything that is done in this field should be too costly, if possible, but I do think, beyond the direct effect, which probably is not too great, there is a psychological stimulus which arises from the fact that most businessmen do want some kind of tax incentive. They feel that is about the only area in which the United States can conceivably effect their foreign operations, and therefore, I think in the spirit of adventure perhaps, more than in its direct affect, you can do something to achieve a changed allocation of resources.

I don't think it ought to be something which is immensely costly because you don't know for sure what your results are going to be.

Senator DOUGLAS. Well, I certainly do not wish to have the spirit of adventure or the glamor of foreign life removed from American experience, but I didn't think there was imminent danger of that, and it would not seem to me that these were qualities which should have preference against more efficient use of our resources when everything is taken into account. It is very interesting to see this plea for venture. I can think of many ways in which it opens up possibilities for our tax system. I think that we should probably remit the taxes on professional baseball players and professional football players because that would lead to a more stirring life of adventure on their part.

And certainly, the principle should be extended into the field of pugilism if that is necessary. Whether it should also be applied to gambling income of Las Vegas and Reno, I do not know, but I would say these very able gentlemen have opened up quite a field, and I am sure that the Congress will hear more about these possibilities in the future.

Now, may I turn to the question of deferral? First, let me see if we have the facts right about deferral.

To what degree, or under what circumstances do we have corporate income earned abroad deferred from the immediate payment of taxes now?

Mr. Wender?

Mr. WENDER. It is now deferred so long as it is not declared, paid out in the form of a dividend, to the parent corporation.

Senator DOUGLAS. Is that true for all corporations?

Mr. WENDER. It is true for foreign incorporated entities, and it applies to their income from sources outside the United States, not to income derived from within the United States.

Senator DOUGLAS. As I understand it, some of you advocate that this principle of deferral should be applied, not merely to American corporations, incorporated outside the United States, but to all income derived from foreign investment. Am I right in that?

Mr. WENDER. That is so. If something were to be done, all of us agreed that this would be a step which we would approve.

Senator DOUGLAS. I thought that was true.

May I say that I think if what you want to do is stimulate additional investment, this would have a greater effect than a reduction in the rate because a reduction in the rate reduces taxes on existing investment. That is not so much of a stimulus to new investment in spite of the very able argument that Mr. Collado has advanced. While we are on that point may I say this question of whether we are going to keep up your stock of existing capital is not one which is peculiar to foreign concerns.

It also applies domestically and therefore, I do not see a need for a differential for foreign firms.

Let's see whether the existing differential is logical and try to determine whether it should be extended. I wanted to send out for a Webster's Unabridged Dictionary to get a definition of deferral but I decided that I thought I knew the Webster general definition sufficiently well so that it would not be necessary for me to do that. As I understand it, deferral means postponement, does it not?

Mr. WENDER. That is correct.

Senator DOUGLAS. But it does not mean cancellation?

Mr. WENDER. No, sir.

Senator DOUGLAS. When would these taxes which are now deferred be paid?

Mr. WENDER. When the money was distributed in the United States or used in the United States.

Senator DOUGLAS. When would that be?

Mr. WENDER. I presume that when you make a foreign investment you make it in the hope ultimately of bringing back profits to the United States.

Senator DOUGLAS. Suppose there is perpetual motion in this business, and growth, reinvested profits, or at least profits which are reinvested are exempted from taxation and they in turn yield more profits, which to the degree that they are reinvested are exempt from taxation, and so forth, so that what we get, is it not, is an ultimate snowballing of capital equities abroad, which have not been taxed, whereas the similar snowballing of corporate earnings inside the United States have been taxed prior to reinvestment.

That is the point.

Now, why should there be this preferential treatment?

Mr. WENDER. You mean why the treatment now?

Senator DOUGLAS. This is what you are advocating. Why should we tax corporate earnings in this country prior to investment, but exempt all investment overseas?

Now if we take the American figures, as approximately half of the corporate earnings in this country are taxed——

Mr. WENDER. I think there are two things——

Senator DOUGLAS. And about a quarter of the earnings are reinvested and a quarter distributed to the stockholders roughly speaking. Now if you say that you would roughly distribute the earnings for

countries in the same way that we do for domestic firms, that is a 50–50 split between investment and distribution, we would exempt half of the corporate income from abroad from taxation.

Mr. WENDER. I think your snowball analogy appropriate. If you want to encourage additional investments, to the extent it snowballs you are accomplishing what you set out to do.

You can melt the snowball by removing the deferral privilege.

You are postponing, not changing the tax.

You assume that income has never been taxed before, and you cite figures that 50 percent is taxed here, and 50 percent remains for reinvestment or distribution to stockholders, but in many countries in Europe, you may have actually paid taxes of more than the 50 percent.

In some countries you have paid less but in most cases you will have paid at least a fairly substantial tax.

Senator DOUGLAS. I will examine that in a minute, but does anybody want to add anything?

This is not compulsory.

Mr. COLLADO. I think I would only like to emphasize what Mr. Wender has said.

First of all, we may have schedules of taxation in all these foreign countries we are talking about, many of which are very nearly as high and in some cases higher than in the United States, so any income we are talking about is the corporate income after the foreign taxation.

Senator DOUGLAS. I will come to that in a minute.

Mr. COLLADO. On the other hand, while it is true that to the extent that you reinvest and reinvest and reinvest, you may argue that a certain income is long delayed in coming home. That is not always the case. There are situations in which in a particular investment you reach a stage of maturity in which you bring home a very large percentage of your income in particular years.

I hate to keep referring back to Creole, but this year Creole has paid out in dividends to its shareholders 93 percent of its earnings. That is one of the very large foreign investments. There the snowball is limited to a very small percent of its earnings.

Senator DOUGLAS. You say ultimately we get earnings abroad and ultimately they come home again.

To what extent can this income be enjoyed abroad, and not taken home in foreign travel and in expense accounts and in luxury hotels, with kidney-shaped swimming pools surrounded by Bougainvillaea.

Mr. WENDER. With travel abroad you could deduct it as an expense of doing business.

Mr. COLLADO. Senator, I should not speak perhaps because I am not a tax specialist. I am supposed to be an economist but not a tax expert.

However, as I understand the provisions of the tax law, if you realize your foreign income in one manner or another, whether or not you actually bring it home, is not the criterion. If you make an effective use of the income from your foreign investment, then it still is taxable.

Now that would relate to people who take their foreign dividends in local currencies and, either because they can't transfer them or because they do not choose to transfer them, make some foreign expenditures. As I understand it in general the foreign expenditures would still be taxable income in the United States.

Now as to your question about fancy expense accounts I can only say the same regime applies on the foreign as well as the domestic side. That is a general problem, not a foreign problem.

Senator DOUGLAS. I once proposed deductions for travel be limited to $25 a day, which seemed to me in simple standards to be adequate but I found it brought down on my head a great deal of opposition, and I did not get very far, but I would suggest that in the interest of simple living, not tax avoidance, it would commend itself to American business.

Mr. BLOUGH. Senator Douglas, the position that I have taken on this has been that adequate safeguards can be and certainly ought to be written into any legislation of this kind so that the purpose in mind, that of promoting foreign investment, would really be served.

I take a somewhat lukewarm attitude even toward this deferral since the results might not justify the costs, but if it is our foreign economic policy to substantially increase and promote foreign investment and we want to do something in the tax field, then it seems to me deferral is the appropriate thing to do and not rate reduction or some of the other tax concessions.

Senator DOUGLAS. I think it is not as bad as a reduction in the average rate. The question is whether we should do it at all.

Mr. BLOUGH. If the Congress decides that for the purpose of promoting foreign economic policy it wants to do something in the tax field, I would like to direct them in the direction of deferral and not in some other direction, but even with deferral adequate safeguards would have to be written into the legislation, especially if branch profits were involved, in order to make sure that what was being deferred was income which was actually reinvested and was accomplishing the results that the whole operation is intending to accomplish.

Senator DOUGLAS. Mr. Costelloe?

Mr. COSTELLOE. I would like to point out the concept of deferral is subject to arbitrary limitation. I do not say arbitrary in any invidious sense. It would be possible to permit deferral of only 25 percent of foreign income or 50 percent.

I must say in a profitable growing business, the cash yield is often less than the profit because of requirements for increased investment in the business.

Mr. COLLADO. Could I add one small point?

I was not in my earlier talk trying to say that your investment decisions of the current nature I am describing are solely the standing still of your operation.

Actually most of the operations that we think about are expanding, some of them greatly and in many cases not merely expanding in exactly the same track that they started out but branching out into related or even unrelated areas. I think you look at all of those. Actually this is a relative and not an absolute matter.

One of your investment decisions can be to pull in your horns and get smaller, and I think that the impact of the various factors, including the tax factor on that are just as important and whether you stand still or get bigger.

Senator DOUGLAS. I would grant that.

The point I was trying to make was that these decisions are not unique in the matter of foreign investment. They apply also to do-

mestic firms. I do not see that they furnish a case for differential treatment of foreign concerns.

Mr. COSTELLOE. May I point out that in the last 10 years the total of all taxpayments of my company has run an average of $5 for every dollar of dividends on common stock, and that although the company has been profitable, its requirements for borrowed capital have mounted constantly. I think that that factor does call for special consideration in the foreign field, particularly where the foreign activity is a matter of choice, to, let us say, an ordinary manufacturing company.

Senator DOUGLAS. There is a third question I want to raise and that is the relationship of foreign taxes, severance taxes, profits taxes, or business taxes upon tax receipts of the American Government.

First let me say that I think the American oil companies avoided some of the difficulties which the British got into in Iran by a relatively liberal policy with the governments of the Arabian Peninsula on the distribution of gains.

I am not going into the question as to whether these governments have always spent the money in the wisest fashion, but I think it has been what we might call an enlightened policy which should, if properly understood, bring great political dividends to the United States, and similarly may I say that I think in recent years, at least, the United Fruit Co. in Latin America has followed an enlightened policy in the revision of its contracts. It has increased the share which local governments obtain from the operation of the business.

As I understand it the contract of United Fruit with the Nicaraguan Government has been revised quite liberally, 42½ percent, I believe, of the profits of the enterprise going to the Government.

I believe there is provision in Guatemala. I shall not go into the political factors lying behind that decision but certainly there is a greater sharing on the part of the American companies with the peopples who inhabit the areas where these natural resources exist.

It is my own belief that this has strengthened our international position in the world and, if properly understood, should remove some of the hullaballoo that the Communists have been raising falsely about this issue.

I want to make my position clear but I would like to ask this:

Has not this attitude been facilitated by the American tax on corporate profits?

There is a dead silence which I sense here.

Mr. COLLADO. Senator, I guess that that question was directed partly at me.

Senator DOUGLAS. No; it is not.

Nobody should feel that they are here on the block, may I say. Nobody is on trial.

Mr. COLLADO. Let me put it a little differently.

As a matter of fact, I was not in this industry nor in this company when a lot of these things started. In fact, I was in the State Department.

Senator DOUGLAS. I do not know about the Venezuelan relationship but I think your company to the degree that it is in the Arabian situation has pursued a very enlightened policy as I understand it.

Mr. COLLADO. Thank you very much, Senator.

I think that you can say that one of the results of the United States Government's tax policy is to make it less painful relatively to pay out more abroad, if you are going to save it at home.

Now that is pretty obvious when you analyze the facts.

Senator DOUGLAS. We should practice economy at home and fair treatment abroad.

Mr. COLLADO. The manner in which foreign taxes and other payments to the country, in which investments are made, varies very greatly from country to country, and that has, of course, given rise to considerable problems. Now it happens that we talk about 50–50, and that has been, as you, I think, suggested, a very happy political—as well as economic situation. It was very easy to demonstrate to the peoples of the countries whose resources were being developed that they were getting a very fair proportion of the total profit arising from the operation, and, as you say, they have been able to command large funds which they could put to good uses. In most cases, I think they have done quite well with the use of those funds.

The forms in which those taxes are taken have frequently not been eligible for the foreign tax credit, and I think in some of these countries there would still be room for a considerable further increase, if you merely retain anomalies of the present United States tax system that we have talked about. I don't think it would be desirable in all these cases to encourage these countries further to increase their tax rates, and I think that the Secretary of the Treasury has already agreed with that.

Now, because of the form of our system, many of these foreign taxes do not give us credit, and we would like to see all of those anomalies removed if possible so that corporate form, as well as other quirks in the law, do not in fact result in our bearing rather heavy double taxation, which I don't think philosophically is intended by most people considering this field.

Senator DOUGLAS. Just a question of fact and it is the last question I intend to ask. If you are in a country where 50 percent of the net profits are given to the local government, and let's say the profits are $10 million, and you pay $5 million in taxes, that $5 million is a credit against what? Is it a credit against taxable income in the United States, or a credit against taxes?

Mr. COLLADO. It is a credit against tax in general. I will ask Mr. Wender to explain but I think you first have to say that it depends in great measure on the form of the payment that you make the foreign government. Not all payments that are credited.

Senator DOUGLAS. Suppose the American tax at 52 percent would be $5,200,000, and you pay tax to foreign governments of $5 million. You have made $10 million. Now is the $5 million deducted from the $5,200,000, leaving $200,000 to be paid to the American Government, or is it deducted from the $10 million, leaving $5 million taxable?

Mr. WENDER. It depends. This is one of the places where you have this peculiarity of form versus substance. But if that had been a branch, the parent company operating directly, you would pay $200,000 to the United States, because it would be an offset.

Senator DOUGLAS. It would be dollar for dollar?

Mr. WENDER. Yes, sir. If your tax abroad were $6 million and your tav in the United States was only $5.2 million, it could only wipe out the $5.2 million.

Senator DOUGLAS. It can't go above a hundred percent.

Mr. WENDER. It can't go above a hundred percent of the tax imposed on income from that country. When you get into a subsidiary form it is a little more complicated, but essentially it works the same way except that only half of it could ever be paid out as a dividend. You are in effect allowed half the foreign tax you pay as credit as against half the income.

Senator DOUGLAS. I will make two comments and then close: This practice that aids companies in becoming more benevolent and kind to the governments where they do business, may possibly have furnished to the Treasury the idea of the dividend tax credit, which similarly is deductible from taxes and not from taxable income. Unless this stirs up the lions, this is the only comment I want to make.

I believe the witness should have a chance to reply to Members of Congress, so I am not going to shut off the discussion until I feel certain that you do not want to reply.

Mr. WENDER. I am afraid I didn't understand your last comment, sir.

Senator DOUGLAS. I was saying that this referred to Secretary Humphrey and the President for his recommendation which was finally enacted into law, that there should be credited against taxes a given percentage of dividends received in a given year, which to my mind introduced a new principle in taxation in that the credit was not against taxable income, but a direct credit against taxes, which in other connections I have denounced as barbarous and unprecedented, but——

Mr. WENDER. I would like to make one comment on that. That we can thank our neighbors north of us for rather than the foreign tax credit because it is the system the Canadians use.

Senator DOUGLAS. We will just say the Canadian tax system is probably one of the worst in the world.

If there is no further discussion, we will adjourn until 2 o'clock.

(The following letter was later received for the record:)

Hon. WILBUR D. MILLS,
Chairman, Subcommittee on Tax Policy,
Joint Committee on the Economic Report,
Senate Office Building, Washington 25, D. C.

DEAR MR. MILLS: In reading the transcript of the hearings of last Thursday, I have the impression that I did not adequately convey two important thoughts to you in answer to your principal question. You asked what justification there is for the $147 million revenue loss which the Treasury estimated would result from the reduction of taxes on existing investment under the Treasury's original proposal for a 14 point reduction in taxes on income from abroad.

The first thought is that the benefits to the Nation that would result from the general rate reduction are worth $147 million even if it is assumed—wrongly assumed, I suggest—that the $147 million cost would not directly contribute to the benefits. Since it would be impracticable—as well as grossly unfair to investors who have already ventured abroad—to reduce the tax rate only on new investments, it might be assumed that the $147 million loss in Government revenue from existing investments would be a pure cost. Even if this were true, I believe the benefits that would flow from the new investment would far outweigh the cost. In fact, however, as I tried to point out in the hearings, the rate reduction on existing investment would encourage growth in the level of investment abroad. Businessmen do not divide their investments in a foreign country into compartments but treat the entire investment as a whole in deciding upon retentions, renewals, and expansions of plant. The same tax factors enter into the hundreds of daily decisions on retentions and renewals as enter into the decisions on expansions. These retentions and renewals of plant contribute

just as effectively as do the expansions to the growth in the overall level of our investment abroad. Also, of course, arguments in equity for a tax change apply equally to existing and new investments. There is the likelihood, moreover, that the $147 million revenue will diminish anyhow, if our tax system is unchanged, as foreign governments are induced by our system to raise their rates.

The second thought is that the benefits to the Nation would not consist solely in furtherance of our foreign policy and in contribution to the expansion of the United States economy. Reform is urgently needed to increase the equity of the United States tax system. In answering your question at the hearings I concentrated, as I thought you wished me to, on the benefits of the former type. Later, in answer to Senator Douglas' question, I tried to explain the need for a new departure in the principles of taxing income from abroad. There is something wrong with the present system which places United States investors at a disadvantage in the presence of strong foreign competition. There is something wrong with a system which effectively encourages foreign governments to raise their rates at the expense of the United States Treasury. There is something wrong with a system which assures the same tax payment on a dollar earned in a low-tax underdeveloped country as on a dollar earned in Canada, where the local government can certainly provide more of the services which make economic activity secure. There is something wrong with a system which imposes no current tax on the income of a subsidiary in Mexico but imposes a high United States tax on the income of a branch engaged in the same business in Mexico. An important justification of the rate reduction and deferral which have been recommended is that they would reduce these inequities and inconsistencies. In a few years, moreover, the changes might well increase above the present level the revenue from taxing income earned abroad; the United States Government would receive more from the personal taxation of an increased United States share of an increased income from abroad.

Let me thank you for the courtesies which you extended to me and to my company during the hearings.

Sincerely yours,

EMILIO G. COLLADO.

(Whereupon, at 12:43 p. m., the subcommittee adjourned, to reconvene at 2 p. m. on the same day.)

AFTERNOON SESSION

The subcommittee met at 2 p. m., Hon. Wilbur D. Mills (chairman) presiding.

Present: Grover W. Ensely, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The members of the panel will please come forward.

The subcommittee will come to order, please.

This afternoon's session of the Subcommittee on Tax Policy will be devoted to discussion of the economic significance of deferred compensation and pension plans.

As was announced this morning, our procedure is to hear from the panelists in the order in which their papers appear in the compendium Federal Tax Policy for Economic Growth and Stability.

At the start of each of these sessions, panelists will be given 5 minutes each to summarize their papers. We will hear from all panelists without interruption. The 5-minute rule will be adhered to. Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session.

I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee's questions.

Our first panelist this afternoon is Mr. Herman C. Biegel, of the law firm of Lee, Toomey & Kent.

Mr. Biegel.

Mr. BIEGEL. The basic question is to determine the equity considerations in the tax treatment of retirement allowances for various classes of taxpayers, primarily the employed versus the self-employed individual.

At the outset, let us note what the laws provide for employed individuals, as contrasted with self-employed individuals, to permit savings for retirement:

(1) The employed individual has social-security coverage on the first $4,200 of his annual compensation. These benefits are extremely valuable dollarwise and are also tax free on receipt.

(2) Many of these employed individuals (estimated at between 12 million and 15 million) are covered by qualified deferred retirement plans.

The tax advantages under these plans are extremely attractive. The employed individual pays no current tax on the amount contributed for him.

The funds set aside are allowed to accumulate tax free. On retirement, when presumably his income is lower, he pays tax on the income as, if, and when distributed to him.

If he receives it in a lump sum, he may apply the low capital-gain rates. And on his death the value of the amount contributed by his employer is exempt from estate tax when paid to a beneficiary other than his estate.

(3) Some employed individuals, especially those in the higher brackets, are able to supplement the benefits of social security and qualified retirement plans by means of individual retirement arrangements, restricted stock options, and so forth.

These, too, have the effect of deferring current income to the retirement period and of transmuting ordinary income to capital gain.

(4) Finally, many employed individuals are able to secure complete exemptions from tax on amounts paid by employers for fringe benefits such as health and life insurance, sickness and hospital plans, and so forth.

While these are not directly related to retirement, nevertheless since the cost burden is shifted to the employer, the employee has a greater amount of after-tax income available for savings for retirement.

By way of contrast, none of these benefits is available to the self-employed. To a large extent the latter is not covered by social security. Nor can he under the present tax laws participate in a qualified retirement plan for his own employees. Moreover, if he maintains fringe-benefit programs for his employees, he cannot be covered unless he pays for his own benefits with after-tax money.

One possible solution has been suggested to Congress by various associations representing professional groups, such a lawyers, doctors, architects, and so forth. (In justice to the individual who first suggested it, this will be referred to as the Silverson plan.)

This plan would permit an individual to exclude from tax up to 10 percent of his earned net income but not in excess of $7,500 each year. Over his lifetime not more than $150,000 could be accumulated.

The funds so excluded would be invested in a restricted retirement fund or a restricted retirement annuity contract. Under both, the in-

dividual could not withdraw any sum until he reached age 65 except in the case of permanent and total disability.

At that time the funds would be taxable as, if and when paid out, as ordinary income, unless the distribution was made in a lump sum, in which event it would be taxable as a capital gain.

It is apparent that this plan is designed to equate the tax treatment of the self-employed with that of the employed individual covered by a qualified plan. While it has merit, there are certain deficiencies which militate against its adoption in toto.

In the first place, the plan would apply not only to the self-employed but to employees not covered by a qualified retirement program. This may provide so attractive a loophole that the entire qualified retirement program may be undermined. For an employer would hesitate to install a broad plan, covering a large segment of his employees, with a fixed annual commitment if, instead, he could pick and choose those employees he wished to benefit and grant them a tax-free raise up to 10 percent of their compensation which they could pay over to a restricted retirement fund of their own.

In the second place, this plan would involve the adoption of a new tax concept, covering a large number of taxpayers, with the attendant administrative difficulties and tremendous revenue losses.

Finally, there is no assurance that the segment of the self-employed who really need retirement income—i. e., those who are in the relatively low income brackets over their lifetime—will avail themselves of the program.

Accordingly, it seems to me that a more practical program might well be as follows:

(1) Amend the social-security laws to cover all self-employed individuals. This will provide these individuals with at least a minimum retirement income. To forestall the argument that the professional and the self-employed "never retire but merely fade away," the present prohibitions on retirees earning more than $1,200 a year should be lifted.

(2) Amend the revenue laws to permit individual proprietors and partners to be included in qualified plans for their employees. The problem of discrimination in favor of the proprietor would be no more onerous here than in the case of the closely held corporation. A whole body of law has been developed on this kind of a plan which would make it relatively simple to administer for a large segment of the self-employed individuals.

(3) Adopt a modified form of the Silverson plan for taxpayers not able to have a qualified retirement plan. Thus those professionals and self-employed who cannot adopt a qualified plan could supplement their social-security benefits by providing benefits under the Silverson plan applicable to earnings in excess of $4,200.

By so limiting the proposal, the number of individuals affected and the amount of money involved would not be too substantial. And the adverse effect on the revenues of adopting a wholesale Silverson plan with its potential loophole for avoiding the present qualified retirement plan provisions would be mitigated.

Mr. MILLS. Our next panelist is Mrs. Eleanor S. Daniel, director of economic research of the Mutual Life Insurance Co. of New York. Mrs. Daniel.

Mrs. DANIEL. The framers of the Internal Revenue Code have seen fit in their wisdom to give certain tax encouragement to private retirement systems. Such tax encouragement must carry a positive burden of proof that the advantage sought is not offset by other adverse consequences for the economy.

Retirement schemes do not merely assure the orderly transfer of claims from economically productive to economically unproductive groups at the necessary time. They may, in themselves, influence the overall effectiveness of the factors of production and the allocation of resources. Both affect the long-term growth and stability of the economy.

The other members of this panel have discussed effects in terms of equity, labor efficiency and mobility, and the distribution of income between spending and saving. My assignment was to explore the implications of the growing volume of accumulated retirement savings, the manner of their administration, and the uses to which they are put. Tax considerations exert very minor direct influence on this process. Therefore this discussion covers some of the ultimate effects of the general tax encouragement given to private deferred compensation systems, the nature of which has already been reviewed by other participants in this panel.

Growth of retirement funds: Private retirement funds aggregated $21.1 billions at the end of 1954, accounting for about 10 percent of the assets of all long-term institutional investors. Although their rate of growth has been more rapid than some other forms of institutional savings, it seems likely to level off. The spurt of the last decade reflects several nonrecurring sources of growth, including the adoption of new plans by very large corporations and a relatively rapid amortization of past service liabilities in a period of prosperity and high corporate taxes.

Furthermore, benefit payments, which are now less than one-fifth of contributions for the uninsured plans according to a recent SEC study, may be expected to rise as plans mature; this will act to dampen asset accumulations.

Present tax laws also work against the concentration in one period of any exaggerated increase in pension savings. Section 404 (a) (1) of the IRC provides that no more than 10 percent of the initial past service liability may be deducted in any 1 year.

Therefore, unless pension costs rise sharply to provide higher benefits and more liberal vesting, aggregate pension reserves might reach, at the most, some $39 billion by 1960. This figure is far below some of the stratospheric projections which have been bandied about. If the American economy continues to expand at its present pace, there seems little prospect of any general secular oversavings difficulty originating in this area.

Influence on economic stability: At the same time, tax regulations permit flexibility in the event of economic strain for either a particular business or the general economy; contributions for any particular year may be reduced or omitted entirely as long as, in the aggregate, accumulated contributions are adequate to meet the normal costs of the plan, plus interest on the initial past service liability.

Despite these variations possible in the rate of funding past service liabilities, pension savings are relatively inflexible and this has been cited as a new potential threat to economic stability in time of busi-

ness downturn. However, there is no assurance these amounts would otherwise have been spent. Furthermore, the pressure of interest assumptions in actuarial calculations requires that retirement funds be invested without much delay. This may drive interest rates lower than would otherwise be the case and contribute to investment recovery.

Finally, the immunity of retirement funds to sudden dissaving means that those who administer them are under no compulsion to aggravate a financial crisis by liquidating investments, and, in addition, the funds may conceivably provide some reservoir of liquidity for other lenders.

Retirement funds also constitute a steadying influence in capital markets in periods of inflation when their relatively stable predictable flow provides a kind of floor of savings.

Administration of retirement funds: The forms of investment into which these continuing flows are channeled varies with the institutions chosen to administer them. Pension plans may be either insured or self-administered; the latter may or may not utilize the services of a trust company.

Uninsured funds are growing more rapidly than insured for a number of reasons. One factor, however, is that insurance companies pay certain taxes for which there is no counterpart in trusteed plans. These include taxes on group-annuity premiums, levied in 17 States, and the Federal income tax, currently fixed at approximately 6½ of net investment income. The premium taxes reportedly amount to under 1 percent of group-annuity premiums. The Federal income tax, which reduces yield at present interest levels by about one-fifth percent, increases the cost of an insured plan by about 5 percent. This presumably involves some tax discrimination against small business which is more prone to use insured plans.

Thus tax policy has had some influence in the more rapid recent growth of trusteed, as compared with insured, plans. The Mills-Curtis bill, now pending, would remove the discriminatory impact of Federal income taxes on insured plans by gradually exempting investment earnings on insured pension reserves. This provision seems to be both equitable and economically desirable.

It should be noted that public control of uninsured funds is less uniform and detailed than it is for insured funds, although no evidence has been found of any widespread abuse. State legislation, like that recently adopted in the State of Washington, requiring mandatory disclosure and periodic examinations, would be desirable.

Investment of retirement funds: The investment of retirement funds is not significantly affected by tax influences. To the extent that taxes are an influence in channeling more savings into uninsured plans, they are conducive to greater investment in securities and less in mortgages, particularly residential mortgages, and to a greater emphasis on common stocks. (For life companies, State investment restrictions, plus valuation problems, have thus far precluded any substantial common-stock investment.)

The types of investment singled out by the IRC provisions dealing with unrelated business income and "prohibited transactions" are too unimportant to have significant economic consequences, and the IRC seems effectively to guard against misuse of the tax privilege.

Equity investment undoubtedly raises the questions of greater significance for the growth and stability of the economy. On the one hand, there are those who feel that the rising flow of funds into retirement channels contributes to a shortage and higher cost of external equity capital, including a scarcity of financing for new, risky, and small enterprises—the venture capital problem. On the other hand, there are those who fear that if pension funds do invest in common stocks such investment may produce a creeping concentration of economic power, and that such funds may go largely into blue chips, creating yield distortions and giving older established companies an unfair advantage in equity financing.

With respect to the first question, i. e., a possible shortage of external equity capital, the primary answer, if such a problem does exist, would seem to be outside the field of tax provisions affecting retirement funds. Even a complete elimination of the tax encouragement given to pension plans offers no solution because these questions may be raised about institutional savings generally, and there are other basic forces besides tax considerations propelling savings into institutions.

On the institutional level, however, a contribution toward a solution seems likely to be made by a gradual process of economic readjustment. To a certain extent the same factors have contributed to the loss of relative position of the large private investor and the growth of institutionalized savings, including pension funds. It was unrealistic to assume that the latter would, in turn, immediately step in to fill the precise holes left in capital markets by the dwindling large private investor. The process has been more gradual and uneven. The institutions first expanded investment in traditional areas and pushed these to the margin of attractive return. As these possibilities were more fully exploited, the institutions turned to new methods and avenues of financing, including equity investment, and they have been aided in this shift by a liberalization of State laws governing investments by fiduciaries and life companies.

In this reorientation of investments, tax considerations have probably set up conflicting currents, some facilitating, and some hampering, the readjustment.

The uninsured funds, which are completely tax exempt, may furnish equity capital on more favorable terms than would an individual investor, since they can absorb losses out of total income rather than only out of income remaining after taxes; furthermore, they are not subject to taxes on capital gains. On the other hand, the Internal Revenue Service has thus far frowned on the accumulation of loss reserves or any considerable surplus, a fact which discourages investments with fluctuating market value and high risk rates, no matter how attractive the yield. Some reexamination of tax policy in this area might be advisable.

Stock investment by insurance companies, which are taxable, enjoys a slight tax yield advantage over other investments, traceable to the 85 percent intercorporate dividend deduction. However, this influence has also been offset by the fact that the security valuation reserves only recently permitted under State laws, in combination with general legal surplus limitations, seem to afford an inadequate cushion against market fluctuations.

It seems likely that, in time, these difficulties may be ironed out and retirement funds will flow into all classes of equities in more substan-

tial volume than at the present time. This will not, however, solve the venture capital problem, although it may lead the individual investors who are bought out of higher quality stocks to transfer their interest to more venturesome outlets. It may alleviate the relatively high cost of equity capital which has prevailed for the last several decades, and it should also contribute to a beneficial diffusion of ownership in American industry.

At the same time, it may raise other problems. These are: (1) greater concentration of corporate control (or alternatively, abdication of active direction, which might be equally disturbing); and (2) possible reduction in the floating supply of stocks necessary for an active market, because of the long-run view inherent in pension-fund investment operations.

As I remarked earlier, none of these problems seem to be of a nature which could appropriately be dealt with through changes in tax provisions affecting retirement funds.

A reduction, and lesser degree of progression, in individual income taxes would probably make the greatest possible contributions to a better balance in the supply of equity funds (and of investment funds generally), assuring: (1) a larger proportion of venture capital; (2) better diffusion of corporate control; and (3) greater breadth in equity markets.

Mr. MILLS. Our next panelist is Mr. C. A. Hall, Jr., professor of economics, Yale University. Mr. Hall.

Mr. HALL. Within the past decade the flow of funds into private plans which defer the payment of currently earned compensation has become large enough to influence materially the rate of saving and capital formation for the whole economy. These private institutional savings are accumulating, for the most part, in corporate retirement and deferred distribution profit-sharing plans for eventual distribution as retirement income or deferred payments to employees.

Additions to reserves of private retirement plans alone rose from about $815 million, or 6.4 percent of personal saving, in 1946, to about $2,820 million, or 15.4 percent of personal saving, in 1954. Comparable data for profit-sharing plans are not available, but additions to their reserves were perhaps less than one-ninth those of retirement plans in 1954.

Continuation through the next decade of the recent forces which have spread the private retirement movement would substantially enhance the absolute and relative importance of these deferred-payment plans. Extension of retirement coverage and liberalization of benefits could expand additions to reserves of retirement plans alone in 1964 to $5,400 million, or 91 percent more than the 1954 level. These funds would represent about 23.6 percent of personal saving at that time.

Federal tax treatment of deferred compensation payments is an important conditioning factor influencing their growth. High and progressive individual income tax rates, combined with the postponement of individual tax on employer contributions to approved plans, have made it profitable for employees, especially the highly compensated, to defer the receipt of compensation from the earnings period to retirement. Deductions allowed employers for contributions to approved plans have placed such costs taxwise on a par with cash

compensation payments. High and sustained employment has served to maintain competition for labor and to stimulate funding of liabilities. Union pressure to initiate retirement plans and to improve employer-financed benefits by collective bargaining has been vigorous since 1949. To prevent widespread tax avoidance and to check the loss of revenue the Congress and the Treasury have surrounded the tax benefits with rigid and complicated restrictions which, in effect, grant the associated deductions and exemptions for firms and their employees largely to approved, or qualified, plans maintained by corporations.

Private deferred-payment plans influence the rate of capital formation and economic growth primarily by altering the amount of total saving (Government plus private) available for investment. If resources released by extra saving are utilized in capital formation, the rate of economic growth at this output level is increased; otherwise, output, employment, and probably the rate of investment are reduced.

Though the flows of funds through plans exert their force on saving through complicated channels and with frequently conflicting results, the combined effect of employer and employee contributions, interest earnings on reserves, and payments to beneficiaries is to increase total savings at the present time, in my opinion. In the absence of compensatory fiscal action to replace the loss of Government revenue due to these plans, my tentative estimates indicate an increase of total savings from retirement plans alone in 1954 varying from 7 to 30 percent of additions to reserves, or an increase of 1 to 5 percent in personal saving, the range depending on the degree to which private saving is supplanted by retirement accumulations. This is a relatively small expansion in saving. However, if tax rates or Government expenditures were altered to remove the increased Government deficit occasioned by plans, the effect on saving could be more important than that arising from the growth of plans by itself. Reduction of Government expenditures by the amount of the estimated revenue loss ($800 million) would have expanded total saving in 1954 by an equivalent amount, or about 4.5 percent of personal saving. On the other hand, an across-the-board increase in personal income tax rates sufficient to restore the revenue loss would have increased total saving by about 3 percent of personal saving. Since these effects are distinct from those of the plans themselves, the combined effect of growth of plans and compensatory fiscal policy would have been to increase total saving in 1954 by amounts ranging from 4 to 9 percent of personal saving.

Continued growth of these plans will probably increase aggregate saving. Assuming future tax rates near present levels, by 1964 these plans might increase personal saving by two to 7 percent, if revenue loss is not offset, and from 7 to 15 percent with compensatory fiscal action.

Changes in the tax treatment of funds flowing through these plans would alter their current and prospective effects on saving. Two important modifications have been suggested in recent years. One proposal would allow the self-employed, who cannot now participate in qualified deferred payment plans, a tax deduction for their contributions to individual retirement plans. Relevant evidence is too frag-

mentary to support a firm conclusion about the effect on saving of such a deduction. But if the deduction limit were set at 10 percent of income up to $75,000, as proposed recently, the result would appear to be an expansion of consumption, that is a diminution of total saving, if revenue loss were not offset. Another proposal would allow an individual tax deduction for employee contributions to qualified plans. This deduction also would appear to reduce total saving in the absence of fiscal actions to replace revenue loss.

Mr. MILLS. The next panelist is Mr. Leonard Lesser, United Auto Workers, AFL–CIO. Mr. Lesser.

Mr. LESSER. It seems clear that retirement programs will be a contributing factor to the economic growth and stability of the United States.

Such programs permit the withdrawal from the labor force of the aged and the disabled worker who would in the absence of retirement income be forced to try to hold on to his job. The retirement of these older and disabled workers will increase the efficiency of the work force. Their retirement will also create additional job opportunities which would otherwise not have existed.

Retirement programs also contribute to an expanding economy through increasing the purchasing power of retired workers and in stimulating increased spending by the unretired worker. The younger worker is likely to spend more freely with the elimination of fears for his own future security and by removing from his shoulders the burden of caring for aged and infirm parents.

Payments under retirement plans tend to cushion the cyclical movement of wages and salaries since the rate at which aged and disabled workers retire is influenced by the cyclical movements of the economy. A downturn in employment is usually associated with an increase in rates of retirement.

In considering the effects which retirement programs have on mobility of labor, it is necessary to recognize that the labor mobility can be caused by different economic circumstances. The mobility of the depressions does little to contribute to the Nation's economic growth. An equally important question is who is to pay for the social and economic costs of mobility. In the past such costs have been borne entirely by the worker and his family. Retirement programs will tend to distribute such costs more evenly.

There is little evidence to support the conclusion that retirement programs retard necessary and desirable labor mobility. The younger employees are generally the most mobile group, and the promise of a small pension at age 65 means litle to them. Figures which have been used to support a contrary conclusion do not isolate the influence of pensions from all those other factors such as the employee's health, work preference, the wages, and working conditions of alternative jobs, which influence a worker in deciding whether to change job.

Any retarding effects of pension plans can be eliminated by the continued development of provisions for full vesting and through the continued expansion and improvement of the Federal social-security program.

Mr. MILLS. Mr. Lesser, we invited you, as you know, to file a paper for the compendium and it is my understanding, as I recall the compendium, that you did not have an opportunity of doing that.

Mr. LESSER. I had the opportunity, but I was unable to find the

time to do it. I have attached a copy of the paper to the summary.

Mr. MILLS. I wanted to ask you if that is the paper, and if it is, I would like for it to be included in the record at this point.

Mr. LESSER. All right.

Mr. MILLS. Without objection, it will be done.

(The information is as follows:)

EFFECTS OF RETIREMENT AND PROFIT-SHARING PLANS ON LABOR MOBILITY, BY LEONARD LESSER, LEGAL CONSULTANT, SOCIAL-SECURITY DEPARTMENT, INTERNATIONAL UNION, UNITED AUTOMOBILE, AIRCRAFT, AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW-AFL-CIO)

At the outset of any discussion as to whether or not retirement plans have an effect on labor mobility, it is necessary to define the kind of labor mobility with which we should be concerned. Mobility of labor can be caused by or result from many factors. All types of mobility do not contribute to the Nation's economic growth and stability.

Statements that the economic growth of this country has been due to, or is dependent on, the mobility of labor, are commonplace. Such statements, however, generally fail to differentiate between the various kinds of labor mobility which have occurred in the past, to analyze whether the different types of mobility have stimulated economic growth or to measure the consequences of the mobility on the workers involved. There is no evidence to support the view that mobility in itself is desirable from the point of view of either the individual or the Nation.

Stated another way, the question which has been assigned to me might better be stated as what kind of labor mobility is desirable in the promotion of economic growth and stability and what effect do retirement plans have on that kind of desirable mobility? Equally important to the question is who shall bear the costs of this mobility. The committee should consider the effect of worker-security programs, such as retirement programs, in distributing the social and economic costs of mobility among the whole economy rather than leaving the sole burden to be borne by the worker.

The history of the United States, although one of continuing economic growth, has been evidenced by various kinds of labor mobility. The depression years of the 1930's produced excessive labor turnover and extreme mobility of labor. This mobility, however, was an involuntary mobility motivated by economic helplessness. Workers were forced to uproot themselves and their families in the vain hope of being able to find work elsewhere. While labor was mobile, I am certain that all would agree that mobility of this kind with its attendant upheavals and social costs, did nothing to contribute to the economic growth or stability of the country. Nor do I believe that continued economic growth requires the existence of a mobile labor force created by the maintenance of a pool of unemployed.

Mobility has also occurred under differing circumstances. The widening frontiers and the promise of newly opened western lands were a major factor in the mobility of the covered-wagon era. For many this was a voluntary mobility motivated by the prospect of economic opportunity and betterment. Labor mobility on a voluntary basis, in an effort to secure economic advancement, is more nearly the kind of mobility which contributes to the economic advancement of the country and which should be fostered.

In addition to considering the different patterns of labor mobility which have occurred and the effect of each as a contributing factor to the Nation's growth, one must also be concerned with the question of who is to pay for the social and economic costs of such mobility. Unfortunately, it has generally been the worker and his family who in the past have had to bear the full cost of mobility.

Programs, both public and private, which are designed to provide economic security for the worker, of which retirement programs are but one small part, can help in redistributing the burden solely from the worker to other segments of the economy. At the same time such programs will not, in my opinion, operate to impair that mobility which is necessary for continued economic growth although their effect may well be to reduce excessive unnecessary labor turnover.

EFFECTS OF RETIREMENT PROGRAMS

The effect which retirement programs have had on labor mobility have not been measured with any precision. There are abundant statements that most private pension plans, in requiring employees to remain with the employer until retirement age in order to secure pension benefits, will tend to restrict the mobility of labor. Similar statements have greeted the negotiation of seniority provisions as well as all other forms of security demanded by labor unions on behalf of the workers they represent. There is no evidence to support a conclusion that seniority provisions which are now standard contract provisions have restricted or slowed down the Nation's economic growth. Similarly, there is no factual evidence to support these statements insofar as they relate to the effect of retirement or pension programs or other programs designed to provide additional worker security.

While the Bureau of Labor Statistics of the United States Department of Labor publishes a statistical series on labor turnover, and while withdrawal or turnover rates for a given age, for a given year, or for a given industry can be obtained, these figures are of no real help in answering the question with which we are concerned. The difficulty is that none of these figures, nor any studies using such figures, have attempted to isolate the influence of the existence of a pension plan from the host of other factors which influence a worker in deciding whether to leave his job for work with another employer in either the same or another locality. Factors such as prevailing economic conditions, homeownership, community ties, health, work preferences, and the wages and working conditions of the alternative jobs, are probably much more important influences than the existence of a pension program or the loss of accumulated pension rights.

The relative unimportance of pension plans seems clear when one considers the labor turnover figures. The rate of voluntary labor turnover is directly related to the period of service and the age of the worker. The quit rate is highest among the younger workers and those with short periods of service. It drops sharply with both increasing age and length of service. Whatever influence the loss of potential pension benefits may have on a worker's decision to change jobs, it is unlikely to prove an important factor for the young worker who has many years until he will reach retirement age or who, because of his few years of service, has little accumulated pension credits with his present employer.

While considerations of old-age security undoubtedly assume greater importance to the older and longer service employee, very little voluntary turnover has been found to exist among such workers even in the absence of a pension program.

Although the real influence of pension plans on labor mobility may be small, pension plans can be designed in such a way as to remove whatever deterrent that would otherwise exist. Labor unions in developing such programs have recognized the importance of minimizing whatever small deterrent may exist and at the same time the need of protecting the worker from having to bear the cost of mibility arising from the loss of old-age security which he has already earned.

One form of such development has been the establishment of pooled industry or area wide pension plans. One example of such a plan is the one negotiated between the UAW and the Tool and Die Association on behalf of some 75 tool and die employers in the Detroit area. Under this plan all employers contribute on the same basis—a specified number of cents for each hour for which their employees receive compensation. A single trust fund is established into which the contributions of all participating employers are deposited and from which all benefits are paid. A uniform scale of benefits is provided. Past service credits are given on the basis of service prior to the effective date of the agreement for any one employer; and future service credits are service accumulated on the basis of hours worked after the effective date with any participating employer. Neither past nor future service credits or any rights to benefits are lost when a worker transfers from one employer to another participating employer.

Plans of this type have now been negotiated in many industries on both a regional and nationwide basis. They assure the continued coverage and pension protection for a worker despite the number of shifts in employment which he may have within the covered group of employers.

At the same time, it has been recognized that the development of area or industry wide pension plans do not protect a worker's accumulated pension rights

if he transfers to an area or to an industry not covered by the plan. To protect the pension credits of workers involved in such transfers as well as the rights of a transferring employee who has been covered under a single employer plan, unions have sought to incorporate provisions for deferred vested benefits in the plans which they have negotiated. Under such provisions a worker who leaves his employer after having accumulated some pension credits, will still be entitled when he reaches retirement age to a pension computed on the basis of his service prior to the termination of employment.

While provisions for vesting have existed in some pension plans for many years, the inclusion of such provisions in plans covering industrial workers is of recent development. Some of these plans provide full vesting after employees have accumulated a minimum number of years of service credits without regard to their age at the time of severance. Others, such as those recently negotiated by the UAW with Ford and General Motors require that a worker, to be eligible for a deferred vested benefit, must have attained the age of 40 at the time of termination in addition to having accumulated at least 10 years of pension credits.

The incorporation into pension plans of provisions providing for full vested benefits would fully protect the worker and eliminate any retarding effect on mobility which such plans might otherwise have.

Other proposals to accomplish the same objectives have been made. It has been suggested that employers with pension plans work out reciprocal arrangements under which workers could transfer from one company to another without the loss of pension credits. Others have proposed that the Federal Government make available for purchase by pension plans annuities which will be payable as a supplement to Federal old-age benefits regardless of the interim shifts in employment which have occurred.

Labor in supporting efforts to broaden the coverage of the national social security system, expand its benefit provisions and increase the benefit amounts, has recognized that complete protection of the worker as well as full labor mobility, can best be achieved under such a system.

We have so far considered only the retarding effect which such plans might have and what can be done to eliminate any such adverse effect.

One must also look to the other side of the coin. The effect which retirement programs have had in encouraging vertical mobility within a corporation, with employees being shifted to fill the jobs left vacant by retiring employees, has long been recognized. It is this factor which was largely responsible for the establishment of pension plans for salaried and executive personnel.

The development through collective bargaining of pension plans covering workers in basic industry such as steel, auto, and rubber has had a much wider effect in promoting economic growth and stability. The establishment of such plans has permitted the retirement of many thousands of workers who, unable to live solely on the benefits provided under the Federal old-age and survivors insurance program, would have been forced to remain at their jobs. The provisions of these plans offering pensions before the age 65 to workers who are disabled, has permitted many more who are not eligible for any benefits under the Social Security Act until age 65, to retire.

The evacuation of the aged and the disabled from the work force has had at least two immediate effects. It has undoubtedly increased the efficiency of the remaining work force. It has created additional job opportunities which would not have existed had not retirement income been available.

An additional area in which these programs have contributed to an expanding economy is through the increase in purchasing power which has been produced. These programs have not only increased the purchasing power of the retired worker through the payment of supplemental pension-plan benefits, they have also stimulated increased spending by the worker who has not yet reached retirement age. Coverage under a planned pension program has eliminated many of his fears as to his future insecurity and loss of income. He has also been relieved of his past burden of taking care of his aged and infirm parents.

Since the rate at which aged and disabled workers retire is generally influenced by cyclical movements in the economy with increased rates of retirement generally evident with a downturn in the economy, this increase in purchasing power is particularly important as an influence in cushioning the cyclical movement of wages and salaries.

CONCLUSIONS

1. Labor mobility can be caused by different economic conditions. All forms of labor mobility are neither desirable nor do they contribute to continued economic growth.

2. The social and economic costs of labor mobility have been borne solely by the worker and his family. Worker security programs of which retirement programs are a part, have helped to distribute the costs of mobility over a broader segment of the economy.

3. Retirement programs probably have little effect in retarding labor mobility which is necessary for continued economic growth. The promise of a small pension at age 65 means little to the younger employees, generally the most mobile group.

4. Any retarding effects on mobility can be eliminated by the continued development of provisions achieving full vesting and through the continued expansion and improvement of the Federal social-security system.

5. Retirement programs can have a positive influence in promoting continued economic growth. In permitting the retirement of aged and disabled workers who would otherwise have to continue at work, these programs have created additional job opportunities. They have also contributed to an expanding economy through increasing the purchasing power of retired workers and in stimulating unretired workers to spend more freely. Benefit payments under retirement programs will tend to cushion the cyclical movement of wages and salaries.

Mr. MILLS. We thank each and every one of you for your appearance this morning, for your full statements in the compendium, and for your summaries.

I had a few questions I wanted to ask members of the panel.

As you know, we are concerned in our study with the impact of tax policy on economic growth and stability. I might say at this point, after having gone through the sessions and the various panels to this day, we have before us quite a weighty problem and question.

In this connection, any Government policy which affects the size and mobility of the labor force is obviously of paramount importance. Our concern with the tax treatment of deferred compensation and pension plans, therefore, stems in the first instance from its impact on the size and the composition of the labor force, and the efficiency with which labor resources are employed.

Professor Hall and Mrs. Daniel, would you comment on this question of the impact of retirement plans on the size and composition of the labor force and its mobility and efficient employment?

I am going to ask Mr. Lesser to join you a little later, but you lead off.

Mr. HALL. I think that I would be somewhat more pessimistic about the effects of the present system of retirement plans on the mobility of the labor force than Mr. Lesser seems to be, at any rate as I understood it from his summary.

To a considerable extent, the lack of vesting provisions in plans has tended to reduce seriously the mobility of executives. I think for similar reasons one could conclude that this would apply also to the wage-earning working force. It seems to me that if there is anything in the structure of retirement plans which ought to be improved at the present time, that this is probably the most pressing thing that needs to be done, namely, to move toward a more fully vested system of rights for workers.

Mr. MILLS. Mrs. Daniel?

Mrs. DANIEL. With respect to the size of the labor force, I would agree with Mr. Lesser that such programs do permit the withdrawal of the aged or disabled worker who might otherwise have to hang on to his job. On the other hand, I am not sure that in the period immediately ahead, where it appears that we may be facing a shortage of labor rather than a surplus—this involves a business forecast, of course—the forced retirement of all older worker would be an unmixed

blessing. However, I believe this result stems from the operation of a good many pension plans, because the framers of such plans have seen fit to incorporate a mandatory retirement age, so that perhaps there is some possible remedy for this particular situation.

With respect to mobility of the labor force, I would agree with Professor Hall in that I am not as optimistic as Mr. Lesser about the self-solving nature of that problem. It is true that younger employees are generally the most mobile group, and as Mr. Lesser says, the promise of a small pension at age 65 means little to them. I think the greatest effect on mobility is felt by workers at the junior management level, perhaps those who have reached age 35 to 45, who have not yet acquired a vested right in their pension, but who might otherwise desire to move from one company to another. I would submit that this interference with mobility is no less serious for the efficient working of the economy than it is when it affects other workers.

Mr. MILLS. Mr. Lesser, as you comment on this question, would you also inject any estimates you might have of the number of these retirement plans that do create a vested right?

Mr. LESSER. Well, I really don't have estimates as to the exact number. Of course, the development of vested programs is not a new one. Many of the plans that were instituted years ago for salaried or executive employees did incorporate some form of vesting provisions. Vested programs for industrial workers, however, is just a recent development.

Mr. MILLS. The reason I ask that question, I thought maybe you did have some estimates or some way to help us with this question in view of a statement that you made on page 2 of your summary. At the bottom of the page you say:

> Any retarding effects of pension plans can be eliminated by the continued development of provisions for full vesting.

You use the expression:

> continued development of provisions for full vesting.

Mr. LESSER. I was speaking primarily of our own experience. In the recent negotiations with Ford and General Motors, we did negotiate provisions for vested benefits.

Mr. MILLS. Is that the beginning of the vested benefit in retirement systems?

Mr. LESSER. Oh, no. There have been vested benefits in retirement systems for some time now.

Mr. MILLS. How long would you say?

Mr. LESSER. I would say probably almost from the beginning of retirement systems. Maybe someone else has more accurate information. I think there are some statistics available, and I can get them and submit them as to the extent of vesting provisions in pension programs.

Mr. MILLS. Without objection, then, they will be inserted at this point.

(The information is as follows:)

A study of industrial retirement plans by the Bankers Trust Co. indicates that 75 percent of conventional plans, defined as plans other than those adopted and negotiated by certain international unions, contain some form of vesting. The following table indicates the variety of provisions:

Extent of vesting in conventional plans

Vesting provisions	1948-50 plans	1950-52 plans
	Percent	*Percent*
No vesting	19	24
Vesting on completion of a period of service:		
10 years or less	14	13
15 years	7	6
20 years or more	10	10
Total	31	29
Vesting on attainment of an age:		
Age 50	1	1
Age 55	2	1
Age 60	2	2
Total	5	4
Vesting on completion of service (usually 10 to 20 years) and the attainment of an age:		
Age 45 or less	7	9
Age 50	9	10
Age 55	17	12
Age 60	5	7
Total	38	38
Immediate vesting without an age or service requirement	3	2
Vesting only on layoff	3	2
Information not complete	1	1
Total	100	100

Mr. BIEGEL. Mr. Chairman, in the 1942 Revenue Act, the Treasury submitted its proposals with respect to the new provisions relating to retirement plans and at that time suggested as a requirement of a qualified plan that benefits be vested within a relatively short period—I have forgotten exactly what the time of it was. I think it was 5 years or something comparable. That provision was eliminated at that time, because the comments made by the opponents were to the effect that the cost would be too great.

Subsequently, some plans have been put in with vesting, and others without. The trend has been in the plans for salaried employees especially those earning over a stated sum of money, e. g., $3,000—and which are supposed to integrate with social security—the trend has been in that type of plan to have fairly liberal vesting, although very few of them give full vesting, but they have graduated vesting after a relatively short period of time.

At the same time, the union, nonsalaried, hourly worker type of plan that was developing, tended to be nonvested almost entirely. However that has been changing in the development of the union plan. Mr. Lesser points out that his own unions have been negotiating them with more liberal vesting. I think the most recent type of plan negotiated by his union provides for vesting after age 40, i. e., for workers who reach age 40, it will apply with respect to all service completed by men after age 30; is that correct?

Mr. LESSER. That is correct.

Mr. BIEGEL. So that we now have in some respects a more liberal vesting provision in the union plan than in many old salary plans. That was illustrated in a case which I had involving a salaried plan and an hourly plan. The salaried plan provided for vesting at age 50, and now the new hourly plan, which formerly had no vesting, has vesting at age 40, recognizing all years of service after age 30.

To sum up, we are at the threshold of much more liberal vesting in the union type of plan and that will, of course, make for more liberal vesting in the salaried type of plan in order to equalize the benefits between them.

Mr. MILLS. Mr. Biegel, I wonder if you would have information as to the relative costs under present conditions of a retirement system with vested rights and with nonvested rights?

Mr. BIEGEL. I am not an actuary, Mr. Mills, but my guess is they would run—it could run at least 50 percent more. Perhaps Mrs. Daniel might throw some light on this.

Mr. MILLS. I wanted to ask Mrs. Daniel that question, too.

Mrs. DANIEL. I am afraid I can't give you the answer to that question. I would like to make two other observations, though, if I may, and I would also be glad to secure that information.

Mr. MILLS. I will come back to you in just a moment for your other observation. Mr. Lesser, what would you say?

Mr. LESSER. My recollection is that 50 percent would be a much too high figure. As I recollect, our actuaries estimated that the cost of full vesting, without any age limit, and with requiring merely a minimum of 10 years of service, would have increased the cost of major industrial plans, with which we deal, by roughly 10 to 15 percent.

Now, I don't have those exact figures here. I do know it was much less than 50 or even 25 percent.

Mr. MILLS. I would suggest that if, Mr. Lesser, you get the figures, and Mrs. Daniel, if you could get the figures, that they appear in the record at this point, without objection.

(The information is as follows:)

COST OF VESTING PROVISIONS

(Supplementary data submitted by Mrs. Daniel at the request of the Honorable Wilbur D. Mills)

The added cost of giving a withdrawing employee an interest in the contributions made in his behalf by the employer will vary, depending on—

1. Whether the employer's contributions vest immediately or only after certain age and service requirements have been met.
2. Whether the contributions vest in full or on a graded, sliding-scale basis.
3. Whether the employee may take the employer's contributions in cash or only as a deferred annuity without cash value.

The rate of labor turnover in the industry is the key factor, however, in comparing the costs of vested and novested plans. In nonvested plans, contributions made in behalf of workers who leave their jobs remain in the fund and may be used either to reduce contributions or increase benefits. In an industry with high turnover the cost of the nonvested plan, other things equal, is less than in an industry with low turnover. The added cost of vesting any plan depends on the rate of turnover and also on the ages and periods of service of those terminating. Usually the added cost will be greater in industries with high turnover than low turnover.

Because of these variables no single, precise figure can be given to measure the cost of vesting. However, according to Mr. Robert A. Wishart of George B. Buck, consulting actuary, a fully vested plan might cost, on the average, some 15 to 20 percent more than a completely nonvested plan. This assumes full vesting after 2 years' service (no age requirement) in the form of a deferred annuity starting at the normal retirement age, with no cash value or death benefit.

Vesting is already fairly common, however.[1] Therefore the potential addi-

[1] A 1955 study by the National Industrial Conference Board of 124 company plans found some vesting in 60 percent of the plans. A March 1953 BLS study of 300 collectively bargained plans found that 25 percent of the plans, covering 16.5 percent of the 5.9 million workers in the sample, contained vesting provisions.

tional deferment of tax revenue if existing plans were revised to this liberal vesting basis would be something less, perhaps 10 to 12 percent.

(Mr. Lesser submitted the following:)

UAW actuaries estimate that the cost of vesting provisions in the plan negotiated between the General Motors Corp. and the UAW amounts to about 5 percent of the total pension costs. Straight 10-year vesting would cost about 6 percent, and 5-year vesting about 9 percent. One must recognize, of course, that one assumption that could make a big difference in the cost of vesting is the rate of turnover. High turnover could double or triple the cost of vesting, but some of this increase would be offset by a decrease in the cost of providing normal retirement benefits.

Mr. Mills. Now Mrs. Daniel.

Mrs. Daniel. With respect to the point that Mr. Biegel was making about the proposal made in 1942, I believe that in Canada approved plans are required to contain certain minimum vesting provisions. If my memory does not misserve me, I think that the benefits must be vested at age 50 after 20 years of service, or something of that order.

The second point I would like to make is that by the very nature of the insured approach to the funding of pension benefits, a good many of the insured plans are vested, particularly those which are financed through individual policy pension trusts.

Mr. Mills. Are the immobilizing effects of these plans, if that is the case, outweighed by their effects on improved employee morale, in considering the efficiency with which personal services are employed? Mr. Lesser, would you comment on that?

Mr. Lesser. Well, of course, since I think that the immobilizing effects—in terms of desirable mobility—are rather small, if any—and since I believe that there is a great positive improvement in efficiecy of the remaining work force by the retirement of the aged and the disabled, as evidenced by figures on absenteeism, and illness, and the like, I would say that the positive effects on efficiency greatly outweigh any possible immobilizing effect.

Mr. Mills. Mr. Lesser, do these plans have a bearing of any kind on employment of relatively older individuals—and I am talking about the so-called over-40-year-age people.

Mr. Lesser. I think there, too, a lot depends on the type of program that you are talking about. Obviously, if a person begins employment with an employer at the age of 40 or 45, and that employer is responsible for providing a full pension for that individual, it will be much more costly to provide it for the older individual than for an individual who began working at age 25 or 30. However, I believe that if it should not have too great an effect on the employment of the older individual a plan provides that the amount of the pension is dependent on the years of service. In other words, if it is recognized in the case of the individual who begins working at 45 or 50, and only works for 15 or 20 years until he reaches retirement age of 65, that his pension will only be based on his 20 years of service, the additional costs are not too great.

Now, there will be some additional cost in the case of an older worker, because of the loss of interest accumulation on moneys that would have gone in at earlier ages, but I think that it is not a major cost factor. Let me state it this way: I believe a plan can be designed which will eliminate a great part of the additional cost by clearly

indicating that the only responsibility of the employing unit is for a pension based on the actual years of service performed with that unit. Such a plan should also have vesting provisions.

Mr. MILLS. Mr. Ture, do you have a question on this point?

Mr. TURE. I wondered if a plan can be devised to minimize the additional cost of employing individuals over 40. Would it be fair to assume that most of the plans generally prevailing today are not so designed and that in fact such plans do represent something of a deterrent to the hiring of people over 40?

Mr. LESSER. I think most of the plans with which I am familiar merely base the size of an individual's pension on his years of service. For example, the Ford and General Motors plans, and other plans negotiated by the UAW provide that an individual on retirement will receive a monthly pension equal to $2.75 for each year of service he has accumulated under the plan.

Now, the individual who starts working at age 45 and retires at age 65 will have accumulated 20 years of service. His pension will be 20 times the 2¼, even though a full pension might be considered to be a pension based on 30 or 35 years of service.

I don't think the additional costs would be too great in that type of situation. I think there will be some, as I say, because of the loss of interest, but the major factor impeding the employment of older persons is not the additional cost of pensions.

Mr. TURE. In other words, actuarial factors?

Mr. LESSER. That is right. But one of the major premises of many statements, that pension plans will discourage the hiring of older workers, has been the theory that when a person retires he will receive a certain amount, regardless of the years of service.

Mr. MILLS. On the whole, do you think that present tax provisions with respect to retirement plans enhance or weaken the built-in flexibility of the Federal revenue system?

Before you answer, permit me to call your attention to three points which are sometimes made in this connection: One, so long as these retirement plans are on the increase, there will be a strong tendency toward increasing savings, regardless of economic conditions, and that this lack of response of total savings to changes in economic conditions will make the job of economic stabilization more difficult; two, the tax provisions serve to remove sizeable amounts of highly cyclically sensitive income, employer contributions on behalf of covered employees, from the tax base so that changes in the amount of this element of employees' compensation are not reflected in taxable income and, three, employers' deductions increase with increases in levels of economic activity and decrease during recessions, offsetting tax revenues perversely.

How would you evaluate these influences in connection with the original question?

Mr. HALL. It probably is true that the savings represented in these plans are relatively inflexible as income changes. There will be some qualifications to this; to some extent actual contributions for past service will fall off as one of the panel members has stated in her paper, but I do think that if one just, for example, considers the current service costs, that they are a relatively fixed proportion of wages and salaries, and that as changes in income occur, this proportion is

more or less constant. This in itself would tend to mean that the built-in flexibility of the system is probably reduced as a countercyclical device.

On the second and third points, I would like to think a little more about them before I gave an opinion. My comment would be restricted then to this first question that you raised.

(The following was later supplied for the record by Professor Hall:)

EFFECT OF RETIREMENT AND PROFIT-SHARING PLANS ON CYCLICAL STABILITY

Deferred-payment plans reduce the sensitivity of Federal tax collections to changes in income. This reduction of built-in flexibility, however, does not intensify cyclical swings of income. On the contrary, it probably increases the cyclical stability of the economy. Apart from cyclical influences, the growth trend of these plans exerts deflationary pressures which will gradually increase over time. This secular force both aids and retards economic stability; expansionary movements are retarded, and contractions are intensified. These conclusions are based on the very limited data now available, and might be altered if more information were at hand.

These plans reduce the built-in flexibility of the Federal tax structure primarily through the impact of employer contributions. Experience since World War II indicates that these contributions are directly related to private wages and salaries, though they are relatively more volatile than cash earnings. Since they are deductible from corporate income and excluded from taxable personal income, they reduce Federal tax collections during booms, and provide no offset to the loss of private income during recessions. The decline of built-in flexibility is not large, however. At the present time a $10,000 million fall of gross national product reduces tax collections by about $3,300 million, as compared to an estimated tax loss of about $3,350 million without any deferred-payment plans. Thus employer contributions alone reduce the flexibility coefficient (change in taxes divided by change in income) from 0.335 to 0.33. Data on other flows of funds through these plans are too limited to provide additional estimates of their cyclical effects on tax collections, but any further influences are relatively unimportant.

Reduced built-in flexibility of tax collections occasioned by these plans does not enhance the instability of the economy. Indeed, the plans appear to increase somewhat the stability of the system. Because contributions vary directly, and payments vary inversely with the level of economic activity, additions to reserves of these plans will tend to move directly with income and employment, increasing in good times and contracting in bad. Without compensatory fiscal policy to offset revenue losses from these plans, the cyclical fluctuation of increments to reserves would be a stabilizing influence. For reasons outlined in my paper, Retirement Contributions, the Spending Stream, and Growth, an expansion of additions to reserves in good times would tend to reduce consumption. This is a stabilizing effect. And the contraction in addition to reserves in bad times would also operate as a stabilizer. Furthermore, any cyclical manipulation of tax rates to offset revenue changes from these plans would intensify these stabilizing effects.

During the next decade or two, powerful secular forces, which are increasing the relative importance of these plans, will blur and at times obscure the countercyclical effects of these plans. By repressing consumption and increasing total saving, deferred-payment plans exert a deflationary effect on aggregate demand. Since these plans will increase in importance with the passage of time, this deflationary effect will also increase with the passage of time. In the absence of discretionary fiscal policy, the progressive deflationary force will be a mixed blessing: it will mitigate booms, but aggravate recessions. Nevertheless, the secular deflationary effect of plans is something quite different from their effect on cyclical stability. That is, deferred-payment plans both enhance cyclical stability and exert deflationary pressures. An analogy is readily available in the individual income tax. Given expenditures, high tax rates are deflationary, yet they increase cyclical stability.

Mr. MILLS. Mrs. Daniel, would you comment?

Mrs. DANIEL. I would also like to restrict my answer to the first question. I had a little difficulty getting the second point you made. Perhaps you wouldn't mind repeating it.

Mr. MILLS. Let me make it again. You understand I am merely pointing out three points that are made in this connection. I am not attributing them to the thinking of the subcommittee. I am merely bringing them to light for your consideration as you answer the major question propounded first.

The second now is this: The tax provisions serve to remove sizable amounts of highly cyclically sensitive income, that is the employer contributions on behalf of employees from the tax base, so that changes in the amount of this element of employees' compensation are not reflected in total taxable income.

Mrs. DANIEL. With respect to the first question, I believe I have already fairly well covered my point of view in my statement. I don't believe that the stabilizing or destabilizing effects of any given flow of saving are purely a matter of simple arithmetic. It is undoubtedly true that pension savings are a relatively inflexible form of savings. They represent a contractual form of saving which, once embarked upon, is continued pretty much without respect to the changing influence of economic conditions.

On the other hand, there is the leeway with respect to the pace at which past service liabilities are funded, stressed in my paper. There is also the additional element which is rather hard to define, or to measure statistically, to which, for want of a better term, I have applied not the adjective "stabilizing" but "steadying," since stabilizing has acquired this connotation of something which must go up and down with economic conditions. When you have a relatively stable and predictable flow of funds which are immune to sudden dissaving, as pension and life-insurance funds are generally, it seems to me that you have a steadying element in capital markets which prevents the kind of cumulative financial liquidation that we saw during the 1930's. I do believe that can be considered a stabilizing influence. By the same token, I think you have a predictable floor of savings in inflationary periods that can be considered stabilizing.

Mr. TURE. Mrs. Daniel, I think that the question is addressed principally to the phenomenon that as there are more plans established covering more employees, and covering larger amounts of total payroll—this represents the growth without reference to cyclical changes in income but just the general spread of retirement plans throughout the economy—as this phenomenon occurs, a greater portion of the current product of the economy is going to be taken out in the form of this type of savings. This will require greater investment outlets. In view of this fact no matter whether or not payrolls are fluctuating because of cyclical conditions, there will be this tendency that savings will not be apt to respond cyclically as rapidly as they otherwise would. I think that is the question which was asked.

Mr. HALL. That is probably true. On the other hand, the outpayments of these plans will also act in a countercyclical fashion. I am not sure whether the one might offset the other effect of inflexible savings.

Mr. LESSER. I just wanted to make the point that Professor Hall did. I think probably in the early years of these plans, the amount going in would be considerably greater than the amount going out,

but as more and more persons retire as these plans progress toward maturity, the amounts going out may be as great or greater than the amounts going in.

Mr. MILLS. In what channels do you think these funds may go? Are they going into Government bonds in the future or are they going into other types of investments to a greater extent?

Mr. LESSER. I think from what I have seen of the investment of these funds that they are being placed, more than in the past, not into Government bonds, but into other types of securities. General Motors was testifying before Senator Douglas' committee, investigating health and welfare programs a few weeks ago, and gave a statement of what they thought a proper investment policy should be.

I don't have a copy of it handy. My recollection is that they thought that roughly one-third of the funds should go into equity investments; that an additional fairly large percentage should go into corporate bonds, and some percentage, I don't recall what it was, but not a terribly large percentage into Government bonds.

Mr. MILLS. I ask the question because I had understood that a recent survey by the SEC showed that an increasing proportion of pension-fund assets are in corporate securities, the most pronounced growth in this direction since 1951 occurring in corporate equities, and they pointed out that the United States Government bonds fell from 31 percent of total pension fund assets in 1951 to 18 percent in 1954, while common stocks rose from 11 to 19 percent over the same period.

Mr. LESSER. I certainly think that is the tendency. I think another big area for pension-fund investment is in the development of projects such as housing, medical-care facilities, hospitals, and the like. I notice recently that according to the New York Times, I believe, it was of about November 20, a very large housing development is being built in New York and is being largely financed by various pension funds. Unfortunately it was not low-cost housing.

Mr. MILLS. I had in mind also, in asking the question, the fact, as I understand it, that the guaranteed annual wage negotiated between your union and Ford Motor Co. provided for the investment of the fund in Government securities, and I wondered if that was reversing or tending to reverse this trend which the survey of the SEC had brought forth.

Mr. LESSER. I don't think it would reverse it with respect to pension plans. The reason for the investment of guaranteed wage funds in Government securities is that those funds have to be relatively liquid. At the point that they have to be liquidated the economy is likely to be in a downturn; which is just the time not to dump industrial bonds and equities onto the market.

Mr. MILLS. The plan can be distinguished, of course, from a retirement plan and the reasons for the difference in investment of assets of a fund likewise should be distinguished because of the need for liquidity versus the need in the retirement plan. That is the point?

Mr. LESSER. Yes, sir.

Mr. HALL. I would like to raise a question, Mr. Chairman, if I may. To the extent that the capital market is fairly well linked together in its various parts, it wouldn't really make very much difference whether the investment policies of these retirement funds were concentrated in bonds or equities or anything else; presumably if they exerted an influence on the market they would drive up prices and drive down

yields of this security and other borrowers, or suppliers in these markets would adjust to these changes in yields, so that somewhere in the system, to the extent that the market is fairly well integrated, you would get really the rate of investment and in various forms, that you would ordinarly get if these funds were, let's say, to open themselves to equity investments completely.

I would like to hear some comment by Mrs. Daniel on this aspect of the question.

Mrs. DANIEL. I would like to second the point that Mr. Hall makes, and this is one of the reasons too, why I am not worried about the question which I misunderstood and was not immediately responsive to, before.

To the extent that these funds represent a relatively new development, they are growing more rapidly than other forms of institutional savings at the present time.

They are therefore, perhaps, growing even more rapidly than your own committee staff projections would indicate as a probable rate of growth for the general economy in the next 10 years.

At the start, they have been going into corporate securities to a very large extent, and in the last 4 or 5 years, their flow of funds has been channeled increasingly into common stocks. That is not peculiar of course, to pension funds. We have had a rising stock market in the past 3 or 4 years, and other investors also have been placing increasing amounts of funds in the stock market.

Within just the last month and a half or so I believe there has been some indication that some of the large funds are now trying to organize their operations so that they can go into mortgages, including residential mortgages, which, as I noted earlier, have been almost completely lacking from their portfolio. That is the kind of linking of the various aspects of the capital market to which I believe Professor Hall is referring, and I think that process will continue. In other words, they will push their investments in each form that appears successively to the margin of attractive return, and if it then seems some other form of investment is more attractive they will go into that particular area.

Mr. MILLS. While we are on the matter of investment of these funds, as you know, there has been a considerable discussion of recent date on the impact of growing pension fund investments in equities on the securities market, and the flow of equity funds. Aside from this forum, there has been considerable discussion, as you know.

One argument has been made that since these funds generally are and must be invested in "blue chip" securities, they contribute to an unevenness of the securities market, and make it more difficult for individual investors to acquire the kind of securities they need to balance their investments. It is also argued that pension funds can immobilize these prime securities since they have generally inactive portfolios.

The combination of these effects, some state, is to exert a great deal of upward pressure on prices of high-grade securities relative to less seasoned issues, with adverse consequences for the allocation of investable funds.

Would you comment on these statements?

Mr. HALL. Mr. Chairman, I think again this is an aspect which is indeed relevant of the thing we were just talking about. To the ex-

tent that your blue-chip equities go up in price, it is true that their yields go down. On the other hand this makes more risky equities more attractive to other buyers, and I think that if there is a high degree of linkage in the various segments of the capital market that the over-all result of this is not going to be as bad as the statements frequently allege.

Mr. MILLS. Would others of the panel desire to comment?

Mrs. Daniel?

Mrs. DANIEL. I would agree with that, and would like to supplement what Mr. Hall has said by saying that I see no reason to believe that any one form of savings, be it in the hands of pension funds or in the hands of individuals, should necessarily spread itself evenly over the market. We all know that there are institutional frictions. They only become bothersome if one form of savings, again, be it in institutional or be it in private hands, is so overwhelmingly important that that in itself would create difficulties on the investment outlet side.

I don't believe that in either Mr. Hall's paper or in mine, that either our present assessment of the importance of pension funds, or even our projections for the next 10 years, would indicate that pension funds are likely to be that important in the total picture.

Mr. MILLS. Do you have any comment, Mr. Lesser?

Mr. LESSER. No.

Mr. MILLS. Mr. Ture?

Mr. TURE. During the stock market shakeup because of the news of the President's illness, the story that came out of the financial district was that the pension funds, as other institutional investors, had contributed a good deal toward arresting the decline in the market by coming in and buying, which seems a good thing.

Of course, to the extent that they did contribute to the arrest of the decline, this would indicate that the scale of their purchases was large enough to have some effect on market prices.

Would that contradict your last statement?

Mrs. DANIEL. I do not believe that it would.

Certainly, there is a question of timing there, too, isn't there, Mr. Ture?

In other words, they could concentrate a large volume of purchases in 1 day but I think that if you look at the public transactions studies of the New York Stock Exchange you will find that for the year as a whole, pension fund transactions are relatively unimportant in the total picture. I can't cite the exact figures, although again I would be glad to supply them.

Mr. TURE. Mrs. Daniel, is that relatively unimportant in terms of total value of all shares purchased, or is it unimportant in terms of total value of various classes of securities that were purchased? For example, if you address this particular allegation to the "blue chip" area?

Mrs. DANIEL. I am afraid they made no such classification; no breakdown of that.

Mr. TURE. Thank you.

Mr. MILLS. Understand, we recognize, of course, that public policy supports growth of these retirement systems. We are merely endeavoring to understand, if we can, what the effect of that growth

may be upon built-in flexibility within the tax structure. If plans are to grow as we anticipate they will, and as of course we desire that the retirement system develop, then it might be necessary in the overall tax policy for economic growth and stability to have offsetting features, if offsetting features should be needed.

That is the basis of our inquiry.

Now, let me have Mr. Biegel's attention if I may.

I take it that you are in favor of the basic principle of the so-called Silverson plan?

Mr. BIEGEL. In a modified form, yes.

Mr. MILLS. Is that in accordance with your modification in your paper, but basically the principle is good?

Mr. BIEGEL. Yes, sir.

Mr. MILLS. In terms of the equity issues involved, is there not an important distinction to be drawn with respect to the situation of many, if not most employees under private retirement plans and what would be the situation of the self-employed under the plan you describe in connection with their respective rights to the retirement benefits?

Mr. BIEGEL. Well, if I understand the question——

Mr. MILLS. Let me put it this way: One of the major reasons why we don't currently tax an employer's contribution to the retirement plan of his employees is that generally the employee has no vested right in the benefits of these contributions. Do you see what I mean?

Mr. BIEGEL. Yes, sir. There is that distinction between the Silverson plan, even as modified in my proposal, and the equitable considerations with respect to private plans for the employee group.

However, so far as I can tell, there is no other way that I know of for permitting the self-employed ever to provide a means of retirement out of their after-tax money that is comparable to the benefits afforded the employee group.

There is one other factor: The self-employed would, under my proposal, be covered by social security, the cost of which he bears, whereas the employee gets at least half of the benefits paid for by employer contributions which are never taxed to him. In other words, the present proposal for covering the self-employed under social security requires that he shall pay three-quarters of the full cost of the social security benefits, whereas, at the present time, the employee only pays half of that, so to that extent the equity runs against the self-employed, and in favor of the employee.

I will admit that, insofar as the vested provisions are concerned, under the Silverson proposal there is an element favorable to the self-employed.

Mr. MILLS. I have had that question in my mind about whether we should enact the Silverson plan in modified form as suggested, because of these different considerations involved in the Silverson plan and the private or employee pension plans.

They do not provide, at least we are told, for the vested rights certainly inherent in the Silverson plan.

Mr. BIEGEL. That is true.

Mr. MILLS. In addition, the Silverson plan, to the extent it is modified, does provide for the deferral of tax on earnings which may be in addition to the vested right, you see, so I do see some differences.

I have raised questions in the past about whether we should enact the Silverson plan in modified form just because we do provide under the Internal Revenue Code for the exemption from tax of the employer's contribution to the employee's retirement fund.

To me, that is not sufficient reason to do it. There may be other reasons of course, but I wouldn't do it just in order to provide equity. Do you see my point?

Mr. BIEGEL. Yes. May I add one point which I have overlooked? In the Silverson plan we are talking about the individual taxpayer's own money. To that extent, it, of course, has to be vested. We are merely permitting him a tax deferment with respect to the treatment of money that he has received, but it is his money and not the employer's money with which we are concerned.

In the case of the employee, we are dealing with money which is not the employee's, and we are deferring for the present, his tax on it. Now, without vesting, it is questionable whether that amount would ever be taxable to the employee. In other words, if I as an employer paid an amount to a fund for the benefit of an employee, and his benefits are not vested, I am almost certain it would not be taxable to that individual anyway. So we are not comparing equal things insofar as giving treatment to the self-employed and to the employed.

Mr. MILLS. Now, the Secretary of the Treasury in observing on the bill that the Ways and Means Committee considered in the last session had a little different view from that which you take about whose moneys we are talking about. He said it would cost the Treasury some 3 or 4 billion dollars to enact the bill before the committee.

He seemed to think that we were talking about money that was owed in taxes to the Federal Government by the individual, rather than the individual's money.

Mr. BIEGEL. Well, I hardly would be competent to pass on these figures.

As I understand it, there would be about $3 billion involved in loss of revenue if the full Silverson plan were adopted, which means that all self-employed, and all employees who are not pensioners, would be covered i. e., those who are employees at the present time and who are not covered by a qualified plan would be eligible to participate in the Silverson plan.

That also assumes that every one of those individuals—and I think the estimate is there are about thirty million of them—would participate to the full extent permitted by the tax laws, namely, 10 percent of their earned net income up to $7,500.

The foregoing estimate, I think, can be broken down so that there is about $100 million involved in loss of revenue if we deal only with the professional group, and about $600 million if we deal only with the self-employed, assuming that these groups exercise their rights under the Silverson plan to the full extent.

I might add one further thing: Before the Ways and Means Committee got through with the Jenkins-Keough bill, they did eliminate from its coverage all those who were employed but pensionless, so that it was limited to the self-employed only, which meant a maximum estimated loss of approximately $600 million.

My proposal, which would eliminate the first $4,200 of compensation on which you could put money away under the Silverson plan, would, I think, cut the heart out of the $600 million loss, because that would

remove a tremendous amount of income from the scope of the Silverson plan.

We would be limited only to incomes in excess of $4,200, which I think would involve a much smaller revenue loss.

Mr. MILLS. Well, by doing that, wouldnt you, Mr. Biegel, just prefer to limit the number of people in the categories involved who could participate under the plan?

Mr. BIEGEL. I would limit it to those groups who I think under the present laws have no opportunity to participate in any kind of a plan.

It is my feeling that the employed-pensionless are covered first of all by social security, to the first $4,200, which covers to a substantial extent, the amount of their compensation; and secondly, in my opinion it is only a matter of time before the greater portion of that group will be covered by private plans, since the means are there for them to be so covered.

Mr. MILLS. When we enact a differential, I think we must always be careful that the facts justify the individual action that we take. This would, in effect, amount to a differential in tax treatment in that it would exclude from the base for tax purposes certain portions of the income of some individuals.

Now, to do that, to me, there must be a very justifiable reason. I can see reasons in connection with the establishment of employee pension plans, which justify the differential that we extend in that area in the corporation tax and permit the corporation to deduct from its income the amount of its contribution in the application of the corporate tax.

Now, what are the compelling public interest and public policies that are involved here that justify the application of the Silverson plan in the modified form you presented for the individual who is self-employed or who does not qualify under an employee pension plan?

Mr. BIEGEL. Of course, we may be differing on basic premises.

I am not suggesting establishing a differential for this group. Rather it is my feeling and that of the various organizations which have promoted or sponsored the Silverson plan that this is a means of attempting to equalize the treatment of this group with the rest of the taxpaying group as a whole. We are not talking of some of the special provisions which were brought out so dramatically before this committee on some earlier occasions. We are talking of a group which consists of as much as 10 million people, a rather sizable group, who are today unable to join for the most part in social security and who, to the extent that they themselves are employers, are unable to provide benefits for themselves as well as their employees, comparable to what the proprietor of a corporate business can.

I refer in that connection to the fact that a number of professional classes, such as lawyers, doctors, and others, cannot perform their services in the incorporated form. Their colleagues on the other side of the business front who can operate in the corporate form may provide for themselves pension benefits comparable to what they give the rest of their employees.

If the lawyer, the doctor, the architect, the accountant, has a number of employees, he can provide benefits for them under the present tax laws, but he must exclude himself.

My proposal would be to permit that group to enjoy the same benefits that the tax laws now provide for the proprietor who operates in the corporate form.

I would also insist, or prefer, that that group be covered by social security. If they want to have some of the benefits, they ought to take all of them and not select those which suit their own particular preferences.

My suggestion is to have social-security coverage for the self-employed in all classes, permit the adoption of qualified plans for those self-employed individuals, who cannot operate in the corporate form, and then, for those few who cannot be covered by the latter type of retirement program, permit a modified Silverson approach for that portion of their income in excess of social security.

I think that such an overall program is not designed to provide them with a differential in tax treatment from the rest of the taxpaying public, but merely to provide them with an equivalent opportunity to secure retirement allowances that the rest of the taxpaying public now has.

Mr. MILLS. Mr. Biegel, I do not want to be in a position of arguing the matter with you. I am merely asking for information, but when you discuss the question of whether this is a tax differential, or whether it merely serves to equate an existing inequity, I find myself compelled to pursue the matter at least one step further. You, I am sure, are very sincere in your thought that a modification of the Silverson plan must be enacted in order to equalize tax treatment.

Mr. BIEGEL. Yes, sir.

Mr. MILLS. But let us look to see whether or not we do it, modified as you would have it, or even as it is included in the bill which the Ways and Means Committee considered some months ago.

For example, there are, I think Mr. Lesser, some 16 or 18 million people who belong to the various unions.

Mr. LESSER. That is right.

Mr. MILLS. Whatever the figure is, you say some 10 million people might be the recipient of this program that you suggest to this committee.

I am thinking in terms of the bulk of the taxpayers still unaffected by benefits either under employee retirement plans or under your plan, who have no tax differential at all in their favor for savings.

What will we do with that group which does still represent a majority of the taxpayers?

Will you say that they receive any benefit at all under any of these suggestions?

Mr. BIEGEL. Of course these figures tend to become blurred.

As I understand it—and I have to accept figures from secondary sources, since I do not compile them myself—there are approximately 70 million people in the labor force today of all kinds.

I think I gleaned that figure from Mrs. Daniels' statement; is that right?

Mrs. DANIEL. Yes.

Mr. BIEGEL. In any event——

Mr. MILLS. That would include the Armed Forces, I think.

Mr. BIEGEL. I would say that practically all of that group, with the exclusion of the Armed Forces, and with the exclusion of the self-employed, is covered by social security up to the extent of $4,200.

Of that group, still talking of the same 70 million, there are about 15 million covered by private qualified pension plans.

Now I do not know how many of the 15 million are included in Mr. Lesser's 16 million of union employees, but we can be sure that most of Mr. Lesser's 16 million will be covered by private plans before very long, and I am thinking not in terms of a long run of 10 years or so, but a much shorter period.

These private plans are growing by leaps and bounds. A private employer who does not have a plan in today's shortage in the labor market finds himself at a distinct disadvantage in bargaining for competent help. He has to meet the demand of his employees for a supplemental private plan, or he will lose his employees. So we are taking care of more and more of the people who are employed but are not now covered by the private plans. The trend is to cover that group under the qualified private plan system.

I suggest covering the self-employed completely by social security, and then permitting those who have employees to adopt plans for themselves.

There is one substantial modification between my proposal and the basic Silverson proposal which should be noted: I would not allow any individual self-employed who has employees to adopt the Silverson plan for himself and thereby be able to exclude his employees from a qualified plan. That is why I make the second suggestion, permitting the self-employed who has employees to adopt a qualified plan so that he must extend comparable benefits to his employees if he is to share. And I would permit the Silverson plan to apply only to that fragment—and I think in the entire labor picture it will be only a fragment both personnelwise and moneywise—of the self-employed who has no employees, and only then with respect to his earnings in excess of $4,200.

Mind you, we are not adopting the Silverson plan in its modified form, or in any form as if it were a compulsory social-security system, whereby everyone is covered. It is merely a means available to those taxpayers who qualify, just as the present revenue laws provide a means for the corporate employer to adopt the plan for his employees. We would be providing the equivalent vehicle to two comparable classes of employees, so that both will be on the same basis. Since many employers have not as yet seen fit to take advantage of the existing provisions for their employees, so I am certain many self-employed will not see the wisdom of adopting the Silverson plan in any form.

It will not be an unmixed blessing to many of them. It merely means that the medium will be available for those who can and want to, to provide benefits comparable to what they could have if they were employees in a corporate form of business.

Mr. MILLS. Mr. Biegel, as a member of the Ways and Means Committee for a period of time, it has been my observation that much of what is now thought necessary to be done in connection with the Silverson plan could have already been accomplished through social security and would have been except for the resistance of the very people who would benefit now under the enactment of the Silverson plan.

I do not mean that they were the only ones who objected but I can remember back when President Truman was in office that he recom-

mended that all these groups be included under social security, and that the tax base be raised to $4,600, with comparable raises or increases in the maximum benefit to be paid.

Arguments were made at the time against the increase in the tax base, and the inclusion of some of this self-employed group that we referred to:

Why should Congress be concerned about the retirement of an individual making as much as $4,800? Could not that individual take care of his own retirement needs by going to Mrs. Daniel and other insurance companies and buying an annuity?

So the Congress would not increase the base and the Congress has not included all of the professional group—not because of any lack of desire on the part of Congress to do so, but because of a lack of desire on the part of these professional groups, as evidenced by their annual meetings on a national basis, as evidenced by their opposition that takes place at those national meetings.

Now you are saying in effect that we include them under social security, that we leave the tax base at $4,200, and because social security does not provide sufficient retirement benefits for this group of individuals, that we supplement social security by adding another system for the retirement of those who are fortunate enough to be able to contribute out of earnings in excess of $4,200.

Now, couldn't we accomplish what you want to do by doing what each and every President since social security has come into existence recommended that we do?

If there are those in the United States about whose retirement we are justifiably concerned, who should not be permitted to retire on a benefit that can be justified with a tax base of $4,200, why don't we include them under social security and provide for a tax base in keeping with the needs of their benefits later on and take care of the situation that way?

Mr. BIEGEL. Mr. Mills, I am a member of the tax section of the American Bar Association, but the position of the American Bar Association does not necessarily reflect either my views or those of all the members of the ABA.

Frankly, I have read a good deal of the literature put out by the ABA on this very issue, and the arguments do not impress me. They might just as well be made against the entire social-security system rather than its application to lawyers and other professional groups.

I think it is of interest to note that the house of delegates of the American Bar Association, early this year, adopted a resolution to the effect that lawyers would like to be under social security, albeit on a voluntary rather than compulsory basis.

I frankly am not able to see why they ever resisted it on a compulsory basis other than the fact that it was something new and lawyers tend to be among the more conservative elements of our population.

Nevertheless, I think the position of the ABA at the present time is in favor of coverage by social security.

For myself, I have no objection, and never have had any, to raising social security from its initial $3,000 ceiling to the subsequent $3,600 or the present $4,200.

And I think one would be foolhardy to think it is going to stop at $4,200. My guess is that it will be $4,800 very shortly and perhaps

higher than that. And to the extent that it does go that high and is available to lawyers, I am for it.

I would only suggest, and I have made it part of my suggested program, that just as we permit under the present Internal Revenue laws, private employers to supplement in a qualified plan whatever social security provides, whether it is at the $3,000 or the present $4,200 level, that we permit lawyers and other self-employed to provide comparable benefits for themselves and their employees on that portion of their income in excess of social-security coverage, whatever it is.

Mr. MILLS. Mr. Lesser, what is your own view with respect to this matter that we have been discussing now for some few minutes?

Mr. LESSER. Well, certainly my own view is that first of all, before anything is done with respect to the Silverson plan, or the modification considered by the Ways and Means Committee last year, or the modification suggested by Mr. Biegel, the Social Security Act should be broadened to cover all of these people.

Mr. MILLS. And the tax base raised to $4,800?

Mr. LESSER. And the tax base raised. Actually, I believe we may have recommended and supported legislation that has been introduced that would raise the tax base to $6,000.

Even with that, I believe the adoption of the Silverson plan would merely create another inequity against the employed worker.

As I understand the original Silverson plan, and the bill as originally introduced, it would have permitted persons not covered by pension plans to obtain a tax deduction for amounts which they contribute out of their own income for their own retirement security.

Now certainly the worker who is covered by a pension plan, which is a contributory pension plan, pays a tax on the amount of his income, which he puts into that pension plan.

He is taxed on that contribution before it goes into the pension plan, even though it is deducted from his wages, and he never receives it at that time.

I think that with the Silverson plan as originally proposed, an inequity would have been created against workers covered by contributory plans.

Now as I understand Mr. Biegel's modification it would remove that particular inequity since all employees who could be covered under a pension plan, even though in fact not covered, would not be entitled to get the benefits of the Silverson plan as he proposed modifying it.

I also understand that he would not give the advantage of the Silverson plan to any self-employed person or individual proprietor who has employees working for him.

In other words, he would limit the benefits of the plan only to the individual who does not have even one employee.

Now I think that that is quite a different proposal than the ones that have been considered in the past.

I doubt if the people who were pushing the Silverson plan would support a limitation which permits it only to be applicable to persons who have no employees.

Certainly those doctors and lawyers who have generally supported it in the past, have at least one secretary or receptionist or a nurse working for them.

Lastly, I think before anything is done to correct any inequity that may be claimed to exist, consideration has to be given to some of the

other inequities and tax favors which have been discussed for the past week and a half before this committee, which favors some of these groups that are now claiming a tax disadvantage. I think that all of those inequities must be viewed together.

To summarize, first, before any consideration is given to these proposals, the Social Security Act be extended and the wage base increased; and second, the modifications proposed by Mr. Biegel be adopted to exclude from any possible advantages those persons who do have people working for them.

Mr. MILLS. Mr. Biegel, let me suggest that you and others who are working in the direction of development of a retirement plan of some sort for these self-employed individuals bear in mind this question of the equity that disturbs me.

I think we will all have to agree, all of us who have been subjected to a study of the law or who practice law as you very successfully do, that a tax deduction to an employer is never equivalent to an exclusion from income for tax purposes.

Mr. BIEGEL. It depends, if you are talking about me as an employer of the people in my firm, in which capacity I stand in the shoes of what might be the proprietor of an incorporated form of business.

In other words, in a firm, let us say, with 20 or 25 lawyers, and an equal number of young ladies, as secretaries, I can put away money for the employed lawyers to the extent that they remain such (before they become partners, which is all too soon these days) and I can put money away for the young ladies, but I cannot put anything comparable away for myself.

To that extent I am at a disadvantage over the man who goes into real estate, with the same background, or stocks and bonds, or digging ditches.

Mr. MILLS. I do not suggest that there is not a disadvantage and I am not opposing the idea that we do what we can to provide some degree of security against old age for these very people that you refer to, but in the process of our taking care of them, let's do it in a way that will result in equity and not create a further differential that will result in the bulk of our taxpayers clamoring for the same or comparable treatment so that we get further erosion in the base of our income tax.

I just offer it as a suggestion.

Mr. BIEGEL. Thank you, sir.

Mr. MILLS. You seem to have been eminently successful so far in the work that has been done on behalf of this idea, and I am sure that as time passes further improvements can be made in the idea, and further acceptance of the idea can occur, but in the process, I was in hopes that you might let me counsel you at least to consider these points of equity and these distinctions between deductions and exclusions.

Mr. BIEGEL. Thank you. I will try.

Mr. MILLS. Mr. Ture has a question.

Mr. TURE. Mr. Biegel, you alluded before to the considerations in 1942 about the amendment of the 1939 Internal Revenue Code in connection with retirement plans.

Was it originally considered that there ought to be a requirement for vesting?

Mr. BIEGEL. That is right.

Mr. TURE. Do you happen to know whether or not, had the vesting requirement been included—whether the employer contributions on behalf of the employee would then have been regarded as currently includible in the employee's taxable income?

Mr. BIEGEL. They would not have been.

Mr. TURE. Is that a possibility, do you think?

Would you consider this as an appropriate suggestion, that, if as Professor Hall suggested, vesting were made a requirement for qualification of these plans, then employer contributions for employees might be included in the employee's current taxable income?

Mr. BIEGEL. No. I think that would defeat the whole concept of these plans and retard their growth and might perhaps cause their curtailment in the future.

I think it is the fact that the employer's contribution are not currently taxable to the employee whether or not they are vested, which makes them a satisfactory medium for providing for the employee's retirement.

Mr. TURE. For the employees. It does not make any difference for the employer.

Mr. BIEGEL. It makes a difference to him only in terms of cost, and as Mr. Lesser pointed out, his actuaries estimate a 10- to 15-percent cost.

I would not dispute that, because frankly my recollection is, hazy.

It may have been that some of the people who spoke against vesting in 1942 were carried away by their own enthusiasm and indicated it might run as much as 50 percent, but certainly it is somewhere in between those 2 extremes, and it is just a question of whether or not an employer can afford it.

I might add this: I think that if we had had compulsory vesting in 1942, regardless of what the real cost was, whether it is closer to Mr. Lesser's figures or to my wild guess, that there would have been perhaps less plans adopted at that time.

I think a requirement for compulsory vesting, or at least partial vesting at the present time, would have little or no effect on the growth of pension plans.

We have gotten our feet wet. Everyone likes these plans. Employees want them, and so do employers. They are going to grow whether you require partial vesting or not—unless you just make them so onerous that they can't afford to be carried out, but requiring vesting is not one of those onerous conditions, in my book.

Mr. MILLS. If there are no further points to be observed——

Mr. HALL. Yes, if I may, please, Mr. Chairman.

If complete and immediate vesting were in fact required in the qualified-pension plan, it might make possible a solution to the equity problem which you have brought up. It then would be possible to count unequivocally to the credit of the employee, either the employer's contribution or his own contribution, since they are in fact both vested and one then might put a ceiling, say, 5 percent of compensation as the normal cost of the plan over either employers' contributions or employees' contributions, and then open this up to everyone, if the inclusion of the self-employed is adjudged by the Congress to be an inequitable situation.

In that case, you would then at least give everyone the opportunity of achieving tax benefits, and there would be very little difficulty in integrating the benefits which you would give to the self-employed and those not now in retirement and pension plans, with those now in pension plans.

Mr. MILLS. Any further comments? Mr. Lesser?

Mr. LESSER. No. I did just come across some old figures on vesting provisions in pension plans, as found by a study made by the Bankers Trust Co. in 1948, but I know that there are more up-to-date figures and I will submit the later ones for the record rather than these.

Mr. MILLS. All right. Without objection, they will be submitted. (See p. 651.)

Mr. MILLS. Mrs. Daniel?

Mrs. DANIEL. I would like to ask Mr. Biegel a question, if I may. His plan for a tax encouragement would apply to savings going into either a restricted retirement fund or a restricted retirement annuity. As one associated with the insurance industry, I suppose I should be overjoyed at this proposal, because I would rather guess that the bulk of the fund would go into a restricted retirement annuity.

What kind of fund did you have in mind as being preferable and what restrictions would there be on tax avoidance if you had the savings going into anything other than insurance?

Mr. BIEGEL. Well, the bills that have been—the Jenkins-Keough bill, and practically all the bills which have dealt with some form of the Silverson plan have provided for two media of funding: the restricted retirement fund and restrictive retirement annuity contract. And in the last days, I guess, of the Ways and Means Committee's consideration of H. R. 9 and 10 there was added a provision permitting them to invest in retirement life-insurance contracts.

Now, the restrictive retirement fund would contain safeguards against tax avoidance by not permitting withdrawals from the fund of any amount until either the employee's retirement, death, or total disability. The same would be true of the retirement income contract. I understand the life-insurance people were quite anxious to have permission to have the investment made in life-insurance contracts as such, but were a little disturbed by reason of the fact that the State laws require that these contracts have a cash value. Therefore I am not sure that if the Jenkins-Keough bill amendment stands, permitting such investment, that you don't have a conflict between the State laws relating to insurance contracts, and the requirements of the proposed Internal Revenue Code relating to investments in those contracts.

Mr. MILLS. Mr. Biegel, are you acquainted with the action that is being taken in the Internal Revenue Service at the present time to establish retirement plans for lawyers and doctors, I believe?

Mr. BIEGEL. Well, the only thing with which I am familiar—and it is merely a rumor we get from the gossip sheets of the trade—is that there is some disposition on the part of Internal Revenue to approve the so-called Kintner type of plan. In the Kintner case, there was a group of doctors who formed what they called an association, and attempted to have that association taxed as a corporation. Therefore, as employee-owners of the corporation, they established a plan covering themselves as well as their other employees.

Internal Revenue refused to approve that plan and the matter was litigated successfully by the association of doctors.

I am told, although I have no direct knowledge to that effect, that Internal Revenue may approve that kind of association for professional people, recognizing it as a corporate form and therefore permitting the proprietors to be recognized as employees of this taxable entity. Accordingly it will permit a plan of such an association to provide benefits for its employees, including the proprietor group.

Now, that was permitted, as I understand it, under a particular statute in the State in which these doctors practiced. To my knowledge, it is not available to lawyers in any State, and not available to doctors in many other States.

Mr. MILLS. In what State?

Mr. BIEGEL. If I had to guess, I would say it was in the Dakotas, but I could be wrong. I don't know why that stands in my mind.

Mr. MILLS. If that could be done, it might accomplish the result that those of you who espouse the Silverman plan have in mind.

Mr. BIEGEL. I think it would take care of people who practice law or medicine in a group. It would not take care of the individual who practices on his own.

Mr. MILLS. Of course, some of the difficulties that we now see in the idea might be overcome by future development of these plans. I was thinking in terms of that when I said it might serve the purpose that you had in mind.

Mr. BIEGEL. It would go part of the way, certainly. It depends on how broad the ruling is. If it recognizes partnerships as taxable entities for this limited purpose, it would go a long way toward solving the problem. If it merely is predicated on the fact that in this particular jurisdiction, what is otherwise a partnership may be regarded as an association (and therefore for tax purposes a corporation) so that the proprietors may be their own employees, which is true of the stockholder-employee of a corporation, and then be covered by a pension plan for employees—if it is limited to that narrow point—then I say it will not go far enough.

However, if it is broader and recognizes partnerships, as such, as taxable entities, then it might go a long way to solve the problems which I am considering.

Mr. MILLS. Thank you.

Are there any further comments by members of the panel? If not, on behalf of the subcommittee I thank you for your appearance today, for the papers which you prepared for the compendium, and for your summaries that you have delivered to us this afternoon. We appreciate that you could take time from your busy lives to be here with us and assist us in these problems that we are considering. Thank you very much.

The subcommittee will stand adjourned until 10 o'clock in the morning.

(Whereupon, at 4 p. m., the subcommittee adjourned, to reconvene at 10 a. m., Friday, December 16, 1955.)

FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY

FRIDAY, DECEMBER 16, 1955

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON TAX POLICY OF THE
JOINT COMMITTEE ON THE ECONOMIC REPORT,
Washington, D. C.

The subcommittee met at 10 a. m., the Honorable Wilbur D. Mills, chairman, presiding.

Present: Senator Paul H. Douglas.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The subcommittee will come to order.

This morning's session of the Subcommittee on Tax Policy will be devoted to discussion of Federal, State, and local Government fiscal relations and their significance for economic stability and growth.

As was announced yesterday, our procedure is to hear from the panelists in the order in which their papers appear in the compendium Federal Tax Policy for Economic Growth and Stability. At the start of each of these sessions, panelists will be given 5 minutes each to summarize their papers.

We will hear from all panelists without interruption. Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session. I hope that this part of the session can be informal and that all members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee questions.

Our first panelist this morning is Commissioner Eugene G. Shaw, of the Department of Revenue of the State of North Carolina.

Commissioner Shaw?

Mr. SHAW. Excluding defense requirements the Federal, State, and local governments each impose about $10 billion annually in taxes. I shall not attempt to discuss the level of government at which various essential functions and services should be performed but point out some of the areas of taxation in which these levels participate and suggest some sources that might successfully be segregated.

Property taxes. The property taxes should be reserved as an exclusive source for revenue for local governments. The Federal Government has never participated in this field and the States have been gradually withdrawing and relinquishing it to local governments. Some State supervision is desirable to improve standards and attain equalization but the source should be left for the use of local governments.

Sales and use taxes. Since the inception of the retail sales tax in Mississippi in 1932 that form of levy has expanded to 31 States and the District of Columbia. Collections have risen from about $9 million in 1933 to $2½ billion in 1953. State-tax administrators have made it work. The desirability of the Federal Government imposing a general sales tax has been considered and debated but it is a source of revenue that should be reserved to the States except perhaps in case of wartime emergency.

Net income tax. The net income tax is the backbone of the Federal tax structure and comprises about 80 percent of its source of revenue. The States imposing net income taxes derive only about 16 percent of their total revenues from this source. In 1953 fourteen States had neither individual nor corporate income taxes. Two others taxed individuals only and three others taxed corporations only.

Thus 19 States were not utilizing this source of revenue. This form of taxation can continue to be employed concurrently by both levels of government and provide the States not now imposing such taxes an available source for future needs.

Death and gift taxes. Many States have imposed death taxes since colonial times but the Federal Government did not enter this field until 1916 as a war measure. Instead of a repeal after the war a tax credit of 25 percent was first allowed and increased in 1926 to 80 percent. So long as the Federal tax was confined to the basic tax, the credit worked out satisfactorily but when the additional taxes at a much higher rate structure were imposed in 1935 for which no tax credit was allowed, the effect was to reduce the value of the tax credit from 80 percent in 1926 to 11 percent in 1953. This source comprising only about 1.4 percent of Federal collections could be relinquished to the States without any serious deprivation to the National Government.

Motor fuels taxes. Motor fuels taxes have been imposed by the States to provide funds for highway construction, maintenance, and repair. The Federal Government first introduced its tax on gasoline in the depression days of 1932 as an emergency measure but has remained in the field.

In 1953 the Federal Government collected about $906 million or 31 percent of the total motor fuels tax. During the same year, there was returned to the States by way of Federal grants for highway construction about $510 million.

This form of tax should be reserved exclusively for highway purposes, and while it is recognized that because of the wide disproportionate mileage of Federal highways that traverse some States, they would require and should receive Federal assistance, it is nevertheless the preponderant opinion of the States that if the present Federal tax on motor fuels should be relinquished to them, they could handle their highway problems without the present Federal highway grants.

Tobacco taxes. The Federal Government was the pioneer in the taxation of tobacco products extending back many years prior to the present widespread popularity of the cigarette.

But the Federal levy is on the manufacture and importation of tobacco. Beginning in Iowa in 1921 States excise taxes on tobacco products were gradually spread throughout the United States and are now imposed by 42 States and the District of Columbia, the latest being the State of Missouri. Rates range from 2 cents to 8 cents on a

pack of cigarettes. In 1953 the Federal Government received about 78 percent and the State governments about 22 percent of total tobacco taxes. This is a valuable source of revenue both to the Federal and State Governments and has not appreciably affected tobacco consumption. Both levels of government should continue in this field on a concurrent basis.

Alcoholic beverage taxes. The taxation of alcoholic beverages is highly diversified and has many different tax bases. The Federal tax is on a unit basis but there are many other measurements for State and local taxes. There is little need for the Federal Government licensing the sale and distribution of alcoholic beverages. This is a function which should be reversed to the States and localities whose enforcement agencies are close to the sale and distribution of the products; however, the excise taxes should be continued by both levels of government as at present.

Mr. MILLS. Our next panelist is Prof. James A. Maxwell, professor of economics, Clark University.

Professor Maxwell.

Mr. MAXWELL. Economic stabilization is the responsibility of the Federal Government. But State and local governments have a stake because economic instability erodes efficient performance of their functions. The Federal Government should welcome effective State and local help because with such help the Federal job would be performed better, while without it, adequate performance will be difficult.

Can State and local governments make an effective contribution toward economic stabilization? The dominant view is that they cannot. This view, which I hold to be erroneous, rests upon overemphasis of the bitter experience of the 1930's, and upon the premise that current fiscal practices of State and local governments—especially constitutionally and statutory restrictions upon taxing, spending, and borrowing—cannot be altered.

My belief that this latter premise is incorrect appears to be shared by the Kestnbaum Commission (the Commission on Intergovernmental Relations) which recently declared that these restrictions could and should be relaxed.

One important restriction in many State constitutions is against deficit finance, or, putting this positively, the requirement of an annually balanced budget. The purpose is to achieve long-run financial stability. This meritorious goal conflicts with the short-run goal of economic stabilization because it means that, in depression, State and local governments raise tax rates and cut expenditures. Then, in prosperity, they rush ahead to make up deficiencies which accrued in depression.

Now the balanced budget requirement of State and local governments is deeply rooted and I assume that it will remain. I propose, therefore, merely modifications and adaptations of existing financial practices so as to make the balanced budget requirement work for economic stabilization. Almost all of the suggestions made in part I of my paper have partial precedents in actual operation; all are within the power of the States and none depend on Federal action.

Appropriate fiscal devices for State and local governments fall under four headings:

(1) These governments should set up tax reserves for current services (a scheme actually in use by New York State and the city of

New York). The logic here is simple. Since economic fluctuations will happen, and since they bring fluctuations in annual revenues, part of the revenue of the abundant years should be salted away to be drawn upon in years which are less abundant. This would serve the double purpose of providing a cushion against recession and a restraint upon the growth of expenditure in boom.

In my paper I outline a possible basis for deciding the appropriate amount of the reserve (enough to guard against the revenue loss from a 15 percent fall in income payments to individuals for a 2-year period), and also a criterion for annual withdrawals from and additions to the reserve.

(2) State and local governments might help economic stabilization by an appropriate scheduling of their capital construction. Capital projects should be held back in prosperity and launched in recession. But a considerable amount of construction must be carried on by State and local governments in prosperous years. The nub of my suggestion is that, in such years, a considerable slice of this be carried in the general fund budget which would be balanced, i. e., it would be financed pay-as-you-go.

When recession comes, the method of finance should shift to borrowing as it legally may. This shift would be expansionary in its economic effects even if the amount of capital spending were not increased. The shift would also have the virtue of relieving the general fund to the amount of the shift, permitting maintenance (even expansion) of expenditure for current services likely to be needed in recession.

If, for example, $150 million of capital projects had been carried pay-as-you-go, shift to borrowing would give a cushion of $150 million annually against a deficit.

In order to put this scheme into effect a government should develop a formal and systematic program of advance planning for a period of 4 to 5 years ahead. Indicators of when to shift the amount and the method of finance of public works would be required. Perhaps the best indicator would be the level of private construction.

(3) State and local governments could assist in economic stabilization by modification of their present rules concerning the time period of debt obligations. Here the aim would be to give some flexibility to the life of the debt. Debt issued in good years might run for less than the useful life of the improvement. This would mean accelerated retirement (an alternative to pay-as-you-go). It would conserve borrowing power. When recession came along, the life of this original debt might be extended by refunding (although not beyond the useful life of the improvement).

Conversely, in recession, debt to finance capital improvements would be issued for the maximum life of the improvement, but with call features that would permit speeding up of retirement in years of recovery.

(4) State governments distribute annually as grants, or as proceeds of State-collected taxes, sums equal to 25 to 30 percent of local revenues. Distributions which are destabilizing—large in good years and small in bad—should be eliminated. Distributions for welfare purposes and for highways should be arranged so as to swell in recession and shrink in prosperity.

Federal devices: The most important intergovernmental device of the Federal Government which might be utilized for economic stabil-

ization is the grant-in- aid. Federal grants amount to $3 billion yearly, one-half of which goes to public assistance and one-fifth to highways.

Grants for these two major purposes could be geared to economic conditions, so that the amount rose in bad years and diminished in good years. A study committee of the Kestnbaum Commission made a report (Federal Aid to Welfare) which examined and recommended schemes of this sort for public assistance, although its recommendations were not picked up by the Commission itself.

Mr. MILLS. We thank you both for the splendid summaries of your presentations appearing in the compendium.

This morning I will ask Senator Douglas to begin the interrogation.

Senator DOUGLAS. Mr. Shaw, I would like to ask you first some questions about the assessment of the general property tax, which as you say, forms probably seven-eighths of the revenue for the support of local and county governmental units.

We know that there are great inequalities in the assessment of general property as between individuals.

Is it your observation that there is inequality as between economic classes, namely, in an industrial town, will the factories be assessed at as high a percentage of their sales value as the residences of the workingmen in those factories?

Mr. SHAW. I doubt seriously that they would, Senator.

There has been an inclination on the part of the local tax authorities to induce industrial development and to give tax concessions and that device is frequently employed in determining the assessed valuation of an industrial plant.

Senator DOUGLAS. I do not want to have it thought that this is a sectional question I am asking you because I have observed the same thing in my own State of Illinois.

In other words, what you are saying is that industrial property will tend to be assessed at a lower percentage of its market value than workingmen's homes.

Mr. SHAW. I think that is true.

Senator DOUGLAS. Would that be true of commercial properties—stores, and so forth?

Mr. SHAW. Perhaps not to the same extent.

Senator DOUGLAS. But nevertheless there would be a degree of difference.

Mr. SHAW. To some degree; yes, sir.

Senator DOUGLAS. What about the percentage of assessment of the homes of the wealthy as compared to the homes of the working-class people?

Let us take an estate worth, let us say, $250,000, and a workingman's home worth $10,000.

Would they bear the same percentage of assessment or would there be differences in the rate of assessment between these two types of properties?

Mr. SHAW. I think perhaps some of the assessors assessing the mansion-type house would be inclined to evaluate it at perhaps a lower percentage of its reproduction cost, but there is this phase of the matter, and that is the marketability for a mansion-type house.

Senator DOUGLAS. That is more on the basis of cost then, rather than sales value?

Let us take two properties, 1 worth $10,000, lived in by workingmen and 1 which costs $250,000, lived in by the proprietor of the mill.

What about the relative percentage of assessment which the local authorities will generally attach to the two types of property?

Mr. SHAW. Of course, the duty of the assessor is to equalize, but I think when he comes to assessing the mansion-type house, he is necessarily going to be impressed with the market value, the resale value, or the number of people to whom such property might be sold, whereas the medium-priced house or the lower-priced house would most always have a ready market value.

I think that enters somewhat into the evaluation.

Senator DOUGLAS. Therefore, the rate of assessment would be lower on the mansion than upon the workingman's home.

Now appreciating that assessors are human beings and subject to difficulties which human beings experience, is it not also true that there would be far more pressure for the underassessment of the mansion than there would be for the underassessment of the workingman's home?

Mr. SHAW. That might be true in some localities.

Senator DOUGLAS. So your general conclusion is that the support of local and county governments as borne by taxes tends to be regressive.

That is, that the percentage paid by low-income groups for the support of local and county government is greater than the percentage of higher incomes?

Mr. SHAW. I would not say lower incomes. I would say perhaps the middle bracket.

Senator DOUGLAS. In any event, and I was simply making a comparative analysis, the percentage paid by those in the upper brackets for the support of State and local governments through the general property tax is less than the percentage on a property basis of those in the lower brackets?

Mr. SHAW. I think that would be true.

Senator DOUGLAS. This has bearing in determining the structure of Federal and State financing as well, because we have to take into account the total burden.

Now let us proceed to the field of State taxation. We have put into the record in other connections the amounts of State tax collection from various sources and these insertions indicated that in 1953–55, approximately 23 percent of State revenues came from sales taxes, 20 percent from motor-fuel taxes, which are like a sales tax, 10 percent from motor vehicle and operator license taxes, which is a type of sales tax. The sum of these aggregate 53 percent. In addition 4 percent of State revenues come from tobacco taxes, 5 percent from the alcoholic beverage taxes, thus coming to 62 percent in all.

Of course what has happened is that as the sales taxes have increased, the proportion of State revenues derived from the property tax has diminished, so that instead of the State getting over half of its income from its share of the general property tax as was true in 1902, that share has now diminished to less than 4 percent. So the States have been getting out of the general property field and have been getting into the sales tax field, and from three-fifths to two-thirds of State revenues are derived from the various sales taxes.

Now it is not true that these sales taxes are quite highly regressive?

That is, if one takes the general State sales tax, it does not fall on investments; does it?

That is, in most cases it is a retail sales tax.

Mr. SHAW. No, sir.

Senator DOUGLAS. So that savings would not be subject to the sales tax?

Mr. SHAW. No, sir.

Senator DOUGLAS. Similarly, medical services and education would not be subject to the sales tax, since these are services.

Mr. SHAW. No, sir.

Senator DOUGLAS. Nor would rents?

Mr. SHAW. Well, the sales tax has been extended in a good many jurisdictions to include the rental of rooms in hotels or motels.

Senator DOUGLAS. But not of apartments?

Mr. SHAW. No, sir.

Senator DOUGLAS. Nor does it include expenditures for personal servants?

Mr. SHAW. There are some jurisdictions that tax personal services, particularly where they are rendered with the sale of a commodity, such as for example, plumbing and electrical repair.

Senator DOUGLAS. But not housemaids, cooks, household servants, and so forth?

Mr. SHAW. No, sir.

Senator DOUGLAS. Is it not true that as a man's income increases, the percentage saved increases, the percentage spent on personal services increases, and the percentage for education and health increase, too—that is the percentage of total expenditures?

Mr. SHAW. Yes, sir; I think that is true.

Senator DOUGLAS. I think the budgetary studies bear that out so the consequence of this is that the State sales taxes also trend to be regressive.

That is, as income increases, the percentage which goes to meet State sales taxes diminishes.

Mr. SHAW. Yes; I think that a person with a high income would buy a relatively lower percentage of tangible personal property, subject to the sales tax, than the person in the low-income bracket, particularly in the States where there is a sales tax on food.

Senator DOUGLAS. So that the net result of this is that we may have a system of State and local taxation which is appreciably regressive.

Mr. SHAW. Perhaps that conclusion could be reached; yes.

Senator DOUGLAS. Would you be willing to strike out the word "perhaps" from your reply? Isn't that right?

Mr. SHAW. My personal view is that the sales tax is the fairest tax that is levied.

Senator DOUGLAS. You may believe in regressive taxation, but I am just going into the question as to the arithmetical fact as to whether the percentage of tax diminishes as income increases, which is the characteristic of a regressive tax, the incremental rates of taxation, of course, diminishing more rapidly than the average rate of taxation.

Mr. SHAW. Yes, sir; that would be true.

Senator DOUGLAS. That is right.

In a paper that Dr. Musgrave prepared and which is printed on page 98 of the Green Book, we see that Dr. Musgrave estimates that

the effective rates for State and local taxes were a little over 11 percent with families or spending units with incomes from zero to $2,000, a little over 10 percent of those from two to three thousand dollars, a little under 10 percent for those from three to four thousand and about that same figure for those from four to five thousand dollars. It drops very close to 9 percent for those from $5,000 to $7,500, under 9 percent for those from $7,500 to $10,000, and for those with yearly income over $10,000, 7.7 percent. I would again like to emphasize that these are average rates, and therefore that the incremental rates diminish more rapidly than the average rates.

That is, on successive slices of income.

Well, now, Mr. Shaw, I regard your testimony as most significant, because you are commonly regarded as one of the most distinguished State commissioners of revenue in the country and I am very glad to get this confirmation of a point which I have been trying to make in these hearings. My point is based on Dr. Musgrave's analysis and such knowledge as I have of State and local finance, gained when I served for some years on the governing body of the city of Chicago.

Of course, it raises a general question as to this: If we believe in proportional taxation, a consequence of this is that we should have progression in the Federal system for taxation to offset the regression in the State and local systems of taxation, and if we believe in progression in the general system of taxation, as I do, it requires still more progression in the Federal system.

Dr. Maxwell, do you have any comments which you would like to make on that point?

Mr. MAXWELL. No, sir. The points that you are trying to establish are pretty old stuff. The economists have been saying them for a long time. One brief comment, the situation differs from State to State. A State like New York has a progressive tax system. A State like Michigan has not.

Senator DOUGLAS. Can you name other States which may have a markedly regressive system of taxation and then some States which like New York, have a progressive system, with the understanding that this refers simply to the rate of taxation?

Mr. MAXWELL. I would do it entirely off the cuff, and I could not go very far in my listing but the States that have not got either corporate or individual income tax almost surely have to have a regressive tax system and there are about 18 of them.

Mr. SHAW. Nineteen.

Senator DOUGLAS. Could you list some of those States?

Mr. MAXWELL. You would get a far more accurate record by looking it up than depending on my memory: New Jersey, Connecticut, Michigan, are the big States in that class; Pennsylvania has a corporate income tax but not an individual income tax. It has also local income taxes.

Well, there are a large number of States in the South particularly that find the individual income tax a pretty hard thing to handle and do not even try.

Senator DOUGLAS. Any other large industrial States which do not have State income tax?

Mr. MAXWELL. Illinois.

Senator DOUGLAS. What about Ohio?

Mr. MAXWELL. Ohio, right.

Senator DOUGLAS. Ohio does have a State income tax?

Mr. MAXWELL. Yes, sir.

Senator DOUGLAS. Wisconsin and California?

Mr. MAXWELL. They have, sir.

Senator DOUGLAS. Wisconsin, I believe, was the pioneer.

Mr. MAXWELL. In 1911.

Senator DOUGLAS. When La Follette, the elder, was Governor of that State?

Mr. MAXWELL. Yes, sir.

Senator DOUGLAS. So that you agree with Mr. Shaw that State and local taxes tend to be quite markedly regressive?

Mr. MAXWELL. Regressive, sir. The figures that Dr. Musgrave presents indicates that the rates run, starting at the lower bracket of income, from over 11 percent down to nearly 7.7, nearly 8.

Senator DOUGLAS. Those are average rates, I might emphasize.

Mr. MAXWELL. I suppose you would call that marked regression but it seems to me that is a rather extreme term to describe the situation.

Senator DOUGLAS. Significantly regressive?

Mr. MAXWELL. Significantly regressive. Yes, sir.

Senator DOUGLAS. Do you agree that this would seem to call for progression in the Federal income-tax structure in order to obtain even proportionality in the general tax structure.

Mr. MAXWELL. Yes, sir; although I think progression can be defended on its own legs.

Senator DOUGLAS. So do I. That is, I would favor progression in the total system of taxation but I say that it is necessary to have progression in Federal tax structure even if one believes in proportionality for the general tax system.

Mr. MAXWELL. Yes, sir.

Senator DOUGLAS. Well, I wish that this testimony, Mr. Chairman, could be more widely noted, because I regard it as extremely significant, and if this could enter into the consciousness, not only of Federal legislators, but State legislators, I think it would have a very beneficial effect.

There is one other question I should like to ask and that is on the debt limits which are imposed upon localities by State constitutions or by State statutes. Generally a given percentage of the assessed valuation is fixed as the maximum amount of debt which the locality can contract.

Now this has been avoided in many cases, has it not, by the creation of new governmental units?

Perhaps you have not used that device in North Carolina?

Mr. SHAW. No, sir. I do not believe it has been employed in North Carolina, Senator.

I might say this: That there has been considerable improvement in a more realistic valuation of property for ad valorem taxes, particularly in the South during recent years, when the local assessors have employed these experts so that there is a much more realistic sound value, as well as tax value, and that, of course, has tended to increase the total assessed valuations in a particular locality.

Senator DOUGLAS. I was simply going into the question of the debt limits at the time being. For instance, in Illinois we created a sanitary district in Chicago which had separate bonding authority, and therefore it was possible to avoid the debt limit imposed upon the city

and the other localities which are in the sanitary district. Is it not also true that the courts have held that one can create an authority whose liabilities are liabilities of the authority and not of the municipality or governmental unit, and which can issue revenue bonds?

I am thinking of the New York Port Authority, our own Chicago Transit Authority in my city, and so forth, so this does increase the power of local governments to carry out capital improvements; does it not?

Mr. SHAW. Yes, sir.

Senator DOUGLAS. Dr. Maxwell?

Mr. MAXWELL. Yes, sir.

Senator DOUGLAS. Now, am I correct in my impression that in the assessment of general property, there has been a much greater approach to 100 percent assessment in recent years, than in former times when it was quite a general practice to assess general property at only a given percentage, or a rough given percentage of its value?

Isn't that true?

Mr. SHAW. Yes, sir.

The assessment of properties for ad valorem taxes I think is done much more scientifically now.

Senator DOUGLAS. But is it not true that in dollar terms they approach much more closely to 100 percent valuation than before?

Mr. SHAW. Yes, sir. That is true. I think there has been much progress made in that direction but there are still many local governments that employ the device of a high rate to compensate for a low valuation.

Senator DOUGLAS. Would you say that there has been a very real tendency to approach 100 percent valuation, or to come closer to 100 percent valuation?

Mr. SHAW. There has been a marked improvement in that direction.

Senator DOUGLAS. Dr. Maxwell?

Mr. MAXWELL. En masse I gravely doubt that there has been an approach to a hundred-percent valuation as compared with the past.

My observations are very limited.

Senator DOUGLAS. Has that always been true?

Mr. MAXWELL. I understood your question to be has there been developed—I don't see from a very limited observation any trend in that direction.

Senator DOUGLAS. Not en masse?

Mr. MAXWELL. Not en masse.That is all I can speak about.

Senator DOUGLAS. You think there has been such a trend over the country, Mr. Shaw?

Mr. SHAW. Yes, sir.

I think there has been an improvement.

Senator DOUGLAS. That has been my general observation. This in itself increases the borrowing capacity of the local governments; does it not?

Mr. SHAW. Yes, sir.

Senator DOUGLAS. Because borrowing capacity is fixed at a given percentage of assessed valuation and if one moves up from, say, 25 percent assessment to a hundred percent assessment, one quadruples the general property base, and therefore quadruples the absolute amount of bonds which can be issued. Isn't that true?

Mr. SHAW. That would be true, but I think there are very few localities that get up to as high as a hundred percent. Frequently, in many States and localities, a sound value will be established and then the assessed value will be a certain percentage of the sound value.

Senator DOUGLAS. I would like to ask, how important are the limitations at the State level on the use of progressive types of taxation?

I am speaking of progressive income taxes, or State corporate taxes.

Dr. Maxwell, I think you have written on this subject.

Mr. MAXWELL. Not specifically, sir. I gather that they are very important. In almost all States that have not amended their constitution to allow it, the law is that you can't do it. You have to have an amendment.

Senator DOUGLAS. Does it require that taxes shall be equal?

Mr. MAXWELL. Equal and proportional.

Senator DOUGLAS. My own State has that provision in its constitution, so that would prohibit progressive taxation upon incomes.

Mr. MAXWELL. There are ways around it. For instance, in Massachusetts, Massachusetts has a tax that sets up categories of income, such and such a percentage of tax upon earned income, such and such a percentage of capital gains, and so on.

That has been upheld by the Massachusetts Supreme Court, even though we still have the clause in the constitution. It always has been there.

Senator DOUGLAS. Gross income tax——

Mr. MAXWELL. No, not that.

Senator DOUGLAS. Excuse me, a gross income tax of a given percent would meet the constitutional test in a good many of these cases, would it not?

That is, a given percentage on gross income. That would meet the equality requirement.

Mr. MAXWELL. I would think so, but it wouldn't be a progressive or even proportional income tax.

Mr. DOUGLAS. I understand, but it would make the State system conform more to proportionality than to regression.

Mr. MAXWELL. I am not sure of that even, sir. Gross income, receipts from any source whatever, seems to me pretty nearly to approach the general sales tax.

Senator DOUGLAS. Well, income spent for services, health, education, and investment which is now exempt from the sales tax would be subject to taxation.

Mr. MAXWELL. Yes, sir. It would.

Senator DOUGLAS. And therefore be far more proportionate than a tax imposed on retail sales.

Mr. MAXWELL. My remarks on that, sir, would be entirely off the cuff, but it would seem to me that a tax on gross income, with no deductions or exclusions or what not, would be a very inequitable sort of tax. Some kinds of income necessarily require a considerable expenditure of income to earn them, a salesman income for instance, and as you are very well aware, the Federal income base of taxable income is perhaps 35 or 40 percent of total receipts of individuals, and if you would try to levy it on 100-percent base, I would doubt very much the equity of the outcome.

Senator DOUGLAS. A proportional tax on net income—what would you say to that; a State proportional income tax on net income?

Mr. MAXWELL. That would be a much better tax, sir.

Senator DOUGLAS. Do you think that would meet the equality requirement of the State constitutions?

Mr. MAXWELL. I am not a lawyer, sir. I would think so, but my opinion is worth nearly nothing.

Senator DOUGLAS. Mr. Shaw?

Mr. SHAW. I am afraid I couldn't answer that, sir. I am sorry. I believe there is one State that imposes a tax on gross income—Indiana, I believe.

Mr. MAXWELL. I believe so, too.

Mr. SHAW. But if I may comment, Senator, on the income tax, I think in most of the States that impose an individual income tax, either have a tax credit or an exemption which tends to make the tax very fair, I think.

Senator DOUGLAS. I am simply dealing with those States which have constitutional provisions requiring equal or proportional taxation. I was suggesting that some way might be found whereby the present regressive system of sales taxes could not, at least partially, give way to a system of proportional income taxes, however income may be defined.

Mr. MAXWELL. Massachusetts law, income-tax law, was designed specifically to get around that back in 1916. It said, "We will impose different rates on different classes of income." It started out at 6 percent on income from investments, 1½ percent on income from salaries and wages, 6 percent on capital gains, et cetera. This was designed to get around the constitutional provision. Massachusetts could not amend its constitution apparently, and that scheme did bring about some progression in the income tax, because it put four times a higher rate on income from investment.

Now, whether that could be adapted to other States I don't know.

Senator DOUGLAS. Did that case go up to the United States Supreme Court?

Mr. MAXWELL. I don't know, sir.

Senator DOUGLAS. It was decided on the State level?

Mr. MAXWELL. I don't know, sir. It has been in existence since 1916 so it must be pretty firmly rooted.

Senator DOUGLAS. Dr. Maxwell, I was interested in your advocacy of Federal grants in aid and I notice that you apparently approve of them for highways, whereas, Mr. Shaw apparently recommends their being discontinued for highways, with the Federal Government giving up its tax on gasoline.

Mr. SHAW. Yes, sir.

Senator DOUGLAS. Would you have the Federal Government give up its tax on automobiles, too, Mr. Shaw?

Mr. SHAW. The manufacturers?

Senator DOUGLAS. I think the Federal Government gets about $900 million a year from automobiles and $900 million a year from gasoline.

I find that taxes on automobiles, trucks, tires, and parts, brought in one billion five hundred million dollars in 1955 and that gasoline, lubricating oil and diesel fuel taxes brought in approximately a billion dollars. You are proposing that the billion dollars be returned to the States. Would you return the $1.5 billion on automobiles, trucks, tires, and so forth, to the States?

Mr. SHAW. Those I believe are manufacturers' excise taxes; are they not?

Senator DOUGLAS. Yes, sir.

Mr. SHAW. No, sir. I think they would fall in the same category as typewriters, adding machines.

Senator DOUGLAS. It is the $1 billion which you would return to the States.

Mr. SHAW. Yes, sir.

Senator DOUGLAS. That would be adequate to meet the highway grants which we are now making, but as you know, there are bills before Congress which contemplate much greater Federal expenditures than a billion a year. Would you say that under those circumstances, the States should meet the extra $1 billion or $1 billion and a half?

You would have the Federal Government get out of the highway business?

Mr. SHAW. Yes, sir. I think they could, perhaps with some few exceptions, like the States of Montana, Nevada.

Senator DOUGLAS. I was going to ask about those States. What would you do about the States of New Mexico and Arizona, where the population is very scanty, but which cover a wide area and you have to go through them in order to get to southern California? Now, if you required New Mexico and Arizona to maintain a highway system, wouldn't that interfere with transcontinental auto traffic?

Mr. SHAW. The only solution I would have for that would be the imposition of a motor fuel tax on all vehicles that traverse those States, requiring the users of those vehicles to purchase in those States motor fuels commensurate with the miles traveled. That is, the so-called Virginia plan.

Senator DOUGLAS. Suppose they reached the State line with a full tank. Would you have them take out a supplemental tank which they would fill up with gas?

Mr. SHAW. No, sir; just simply require them to pay the tax equivalent to the number of gallons——

Senator DOUGLAS. On the amount of gas which they would use up?

Mr. SHAW. Yes, sir.

Senator DOUGLAS. Then supposing if in addition to their trip through the State on their way to southern California they stopped off and visited Phoenix, Tucson, and traveled around Arizona and went down to New Mexico, and so forth. They would be on their own as to stating the amount?

Mr. SHAW. Senator, the State of Virginia has successfully policed and collected that form of motor-fuel taxes now for a number of years, and the State of North Carolina enacted it in 1955.

Senator DOUGLAS. Well, I must confess then that I was not aware of this tax, and I think probably should make amends to the State Highway Commission of Virginia, because in my annual pilgrimages to Monticello I have not paid this amount to the State of Virginia, and was not aware that it was obligatory upon me and if there is any representative of the State of Virginia here, I should be glad to have them estimate how much I owe the State of Virginia for these trips. I will be glad to mail them a check for that amount. But I must say that I was never stopped at the Potomac River and people never asked me

where I was bound. I would gladly have paid them, trying to be a law-abiding citizen, if I had been asked but I was never asked.

Mr. SHAW. I regret to say that I didn't mention to you that the tax is imposed on commercial vehicles.

Senator DOUGLAS. Well, yes, on the trucks, you mean.

Mr. SHAW. Yes.

Senator DOUGLAS. Then I have not been in violation of the law. I feel better about that, but after all, these highways are not used entirely by trucks and commercial vehicles. A large percentage of the traffic is that of people pleasure bound or business bound in ordinary cars.

Mr. SHAW. Yes, sir; that is true, but I am convinced that all motor-fuels taxes should be segregated and allocated for highway construction, maintenance, or repair.

Senator DOUGLAS. Of course, that is constitutionally impossible so far as the Federal Government is concerned, but we have reached a rough approximation of it with the present appropriations, over my protests I may say, but those have very little weight, so that there is a rough approximation of that now.

It has been a long time since I read the books on the development of the British highway system, but as I remember the development of the British highway system the support of each piece of road was originally charged upon the property owners adjacent to that road, but gradually it become evident that the property owners were maintaining the roads for people other than themselves, and that town dwellers were using the road and country dwellers were maintaining them so the area of support of the King's highways—I believe it was called in England—increased, to larger and larger units until finally they had, I believe, almost national support of highways; isn't that true?

Mr. MAXWELL. Yes, sir.

Senator DOUGLAS. Of course, England is a much smaller area geographically than ourselves but I think the force that has been operating here is an attempt to get the unit of support similar to the unit of use, and while the gasoline tax may make it much more possible to do this than the general property tax does, nevertheless we have the problem of localities or States which have high traffic from outside their State. There is one other question. I have always felt the obligation of the Federal Government should not extend to the provision of a secondary system of roads, that is, feeder roads. I thought the responsibility of the Federal Government was largely confined to interstate highways, but my colleagues from the South and Southwest have a very different view on this point, and they want to have the feeder roads supported in large part by the Federal Government, too, and I seem unable to convince them that the responsibility of the Federal Government does not extend to those roads.

What is your feeling on that?

I don't want to put you in an embarrassing position, Mr. Shaw, but I am frequently amused by the fact that people, some of the people, who talk most about States rights and recentralizing government are nevertheless very keen for Federal appropriations for secondary highways, which would seem to me to be a local responsibility.

Have you any explanation of this enigma, Mr. Shaw?

Mr. SHAW. Well, Senator, I am not an expert on highway affairs. But speaking only personally, it is my view that the maintenance,

construction and improvement of secondary roads should be the responsibility of the State.

In North Carolina, in 1949, the people voted an additional 1-cent tax on gasoline to provide for a debt service to retire $200 million road bond issue, all of which was allocated to the construction of secondary highways. The State has a very wonderful system of secondary highways.

Senator DOUGLAS. I believe that was done when our distinguished colleague, Senator Kerr Scott, was Governor.

Mr. SHAW. Yes, sir.

Senator DOUGLAS. That is one of the many great contributions he made when he was Governor of North Carolina. I have always regarded North Carolina as in many ways a model State, Mr. Shaw. I wondered if we couldn't get your example working amongst the other States of the South, Southwest, and West.

Mr. SHAW. I might say this, Senator, that this additional 1 cent of tax, was especially earmarked for the debt service of these bonds, and the accumulations for this debt service, are way ahead of original schedule.

Senator DOUGLAS. May I turn to the subject of estate and gift taxes, which on the Federal level we are going to consider this afternoon. As I understand your papers, they recommend that the Federal Government get out of the estate and gift-tax field and turn the matter over to the States.

Mr. SHAW. Yes, sir.

Senator DOUGLAS. This was true prior to the passage of the Federal estate tax in the 1920's. Do you know what happened then? As I remember it, competition set in amongst the States to lower the estate taxes and I particularly remember the State of Florida, which passed a consitutional amendment prohibiting the inheritance tax from ever being imposed by a Florida legislature. This was in the height of the Florida real-estate boom. The aim was to induce wealthy and aged northerners to come and spend the declining years of their lives in the sunshine of Florida, and to be able to die without having their estate subject to taxation. This was very popular, not only amongst the old people, but amongst the young people, because while they didn't wish their parents any ill luck, still if they had to die, how much better it would be for them to die in Florida, where there would be no estate taxes and where the children could inherit the entire property. As a result there was a great exodus of northerners into the beautiful State of Florida, and Palm Beach and Fort Lauderdale, and the other places which were built up quite rapidly.

This induced other States to follow the example. The State of Maine, for instance, was about to pass a constitutional amendment prohibiting income taxation. They were not competing for the winter business, but for the summer trade, and it would be possible to go up into the air-cooled regions of Maine in the summertime, establish residence there, and be immune from taxation, and indeed they could become wandering birds, go to Maine in the summertime and Florida in the wintertime, and they would be completely outside State taxation. The State system of inheritance taxes began to break down. Do you remember that history? You don't have as much white hair, Mr. Shaw, as I have.

Mr. MAXWELL. I remember it, Senator.

Senator DOUGLAS. What I am describing is true, is it not?

Mr. MAXWELL. Yes, sir.

Senator DOUGLAS. The President at that time was Calvin Coolidge as I remember it, and the Secretary of the Treasury was Andrew Mellon. Neither of these men could be accused of being in lead of the dark forces in the country and yet they introduced a Federal estate tax, with the provision that if a State had a State inheritance taxation, 80 percent, I believe, of the Federal tax would be rebated back to it, so that then the people in Florida discovered that after all they had not escaped taxation; that the arm of the Federal Government reached down there and when they died they would have to pay their taxes, but the money, instead of going to Tallahassee, would go to Washington.

As I remember, the State of Florida rose up in indignation and declared that this was an intrusion, as you said, upon the sphere properly marked out for exclusive State action, and the case went up to the United States Supreme Court and Andrew W. Mellon himself was at least, if not figuratively hailing the court on the ground of unconstitutionality for passing this tax. I think Judge Andrew Green of Pennsylvania was chairman of the House Ways and Means Committee at this time, and one of the most conservative of men, and the Supreme Court, by unanimous opinion, told Florida to go back to Tallahassee and sit down.

Now, are you proposing to restore this chaotic system, which would mean the virtual disappearance of inheritance taxation in the United States?

Mr. SHAW. No, sir; I think the Federal Government could continue to remain in the death-tax field, but I think if they do, then the additional estate-tax rates which were imposed during the Roosevelt administration in 1935 should be taken into account in determining the 80-percent credit.

Senator DOUGLAS. You want to return to the system of the twenties?

Mr. SHAW. Yes, sir.

Senator DOUGLAS. Well now, that raises some suggestions in the field of income taxation.

Would it not be possible for a coordinated system of Federal and State income taxation, in which the Federal Government would collect all income taxes, whether State or Federal, but rebate a portion of that to the States?

Mr. MAXWELL. It would be a fine thing for rich States, if you are going to rebate it back on the basis of origin of income. It wouldn't do much for the poor States. That is one of the big flaws in that scheme.

Senator DOUGLAS. You would say it would have to be supplemented by a system of Federal aid?

Mr. MAXWELL. Yes, sir.

Senator DOUGLAS. Or grants-in-aid.

Mr. MAXWELL. You could distribute it on another basis if you like, but if you distribute it on the basis of origin it would principally be beneficial to the rich States.

Senator DOUGLAS. Would it not make it possible for the State systems of taxation to be less regressive?

Mr. MAXWELL. Yes, sir; I think if they got reasonably common definitions of income and what not, maybe you could even have different rates levied by the different States; the Federal Government would collect and rebate it back. I would like to see more States have income tax than have.

Senator DOUGLAS. I am not proposing that it replace Federal aid.

Mr. MAXWELL. As a supplement; as another move altogether.

Senator DOUGLAS. But as a means of enabling the States to get at income which now does not bear its proportionate share of taxation within the States.

Mr. MAXWELL. I think a State income tax is a good thing, and I would like to see more States adopt it, regardless of Federal aid.

Senator DOUGLAS. But it is somewhat difficult to get the States to.

Mr. MAXWELL. Yes, sir.

Senator DOUGLAS. Wouldn't this possibly overcome their reluctance?

Mr. MAXWELL. It might, sir. There are lots of techniques that you might use to push the State governments if the Federal Government is willing to do that.

Senator DOUGLAS. This is not a new idea. I studied for a brief time public finance over 40 years ago under Professor Seligman of Columbia, who was then the leading authority on public finance, advocating this proposal as early as 1913.

Mr. MAXWELL. He went further than that, sir, and wanted the Federal Government to collect the tax in toto.

Senator DOUGLAS. I don't even say that I necessarily advocate what I am suggesting, but I am throwing it out as a possibility. I think that is all, Mr. Chairman.

Mr. MILLS. Mr. Ture of the staff will interrogate the panel.

Mr. TURE. Much of the testimony I think we have heard so far suggests the importance of built-in flexibility in the overall revenue system as a means of mitigating the problems of counteracting wide fluctuations in income and employment, and I think a large number of panelists have suggested that to have a revenue system which is characterized by built-in flexibility, the principal emphasis has to be placed on income taxation, suggesting that other forms of taxation are much more sluggish in their response to changes in income.

Now, the data that Senator Douglas was referring to a short time ago show that, roughly, over the last decade, there has been very little change in the proportion of total State revenues derived from sources other than income taxation. I think those percentages are in the neighborhood of about 80 percent, something of that order of magnitude, which are derived from property taxes and excise taxes, sales taxes, other kinds of taxes which seem to make a very minor contribution to built-in flexibility in a revenue system.

Does the fact that for over 10 years there has been so little change in the overall character of State revenue systems in this respect indicate that this is a fairly fixed situation, or are there any prospects, in your opinion, that in the foreseeable future the States will move toward a revenue structure which contributes more to built-in flexibility?

Mr. MAXWELL. Who do you wish to answer, Mr. Ture?

Mr. TURE. Both of you gentlemen, please.

Mr. MAXWELL. I do not think there are very many prospects of increasing the built-in flexibility of State and local tax systems in the near future.

Their whole effort is to secure what they call financial stability. They want to get revenue in the bad years because they are tied by their constitutional or statutory provisions with respect to unbalancing their budgets. If you have that statutory or constitutional requirement you have simply got to have taxes that bring in money in bad years.

Therefore the built-in flexibility of the State and local tax systems is necessarily, I think, judging what they have, necessarily perverse, and I do not see any marked change in the foreseeable future.

Mr. SHAW. I think there has been an expansion in various types of consumer taxes by the States during the past 10 years, notably the tobacco tax, and the general sales tax.

I do not recall that any States have imposed individual or corporate income taxes during that period.

Of course, generally speaking, in most States, the two giants in the revenue family are the income tax and the sales tax.

Mr. TURE. With the sales tax being the greater of the two giants?

Mr. SHAW. I think so, because the sales tax is now imposed in 31 States and the District of Columbia and comprises about one-fourth of total State revenues, approximately $2½ billion annually out of about $10 billion the States receive.

Mr. TURE. I think the context of the query is this: that we have seen a number of fairly long-range projections of economic development in this country, including one prepared by the staff of the Joint Committee on the Economic Report on potential economic growth in the United States.

According to many of these projections, on the assumption that the international situation does not become greatly worse, and if there is a good possibility of stabilization for Federal defense programs, the growth of the economy will mean that the scope of Federal fiscal operations, relative to gross national product, will decrease. On the other hand, with a rising population and with rising living standards, the State and local governments will be called upon to provide a continually increasing level of public services, so that their budget operations will tend to become relatively more important while the Federal Government's operations then become relatively less important.

Now there is the fear that some folks have expressed in the situation, that as the Federal tax system becomes relatively less important overall we will be losing a stabilizing influence and this will be replaced by the increasing importance of State and local government revenue systems which are not major factors contributing to economic stability and perhaps are even destabilizing, so that the question comes up, is this a source of considerable concern in the area of Federal tax policy.

In other words, should this be planned upon, or taken into account and attempts made to increase the built-in flexibility of the Federal revenue system to offset this development.

Do you have any comment on that?

Mr. MAXWELL. It seems to me that would be a rather long way around of doing it. I think that the built-in flexibility of the Federal

tax system probably should be increased somewhat but I do not think that you can go very far in that direction.

I would like to point out that the main tenor of my paper is that we should try to get steps to increase the built-in flexibility of State and local tax systems, by these four devices that I outlined in my paper, instead of letting the whole burden rest upon the Federal Government. And it will be a harder and harder burden, I think, if we happen to get a reasonably happy world ahead.

Instead of letting the burden rest upon the Federal tax revenues, see if we cannot devise something to put more built-in flexibility, withour radically altering them—that is, impose, I think—more built-in flexibility in the State and local tax systems; and as I see it, there are relatively easy devices at hand.

I have outlined, or tried to outline, four of them briefly.

Mr. TURE. I think we are all very much impressed with that outline.

Mr. MAXWELL. I might say, sir, the ideas are not mine. More of the ideas belong to Fred Bird who, unfortunately, is not here, than to me, but most of them will be found outlined in a report of a New York commission that he chaired, a commission that reported last March.

Mr. TURE. I think every one will agree that it will increase the stabilizing capacity of State and local government budget operations, but is this built—in in the sense that these are automatic responses at the State and local level to change in economic conditions or do they require an express determination on the part of the fiscal authorities of the State and local governments to make the changes that you suggest at the appropriate time?

Mr. MAXWELL. You could build it in automatically if you wish, just the way the agricultural price supports are built in, by a statutory device.

That is, built-in flexibility, it seems to me, applies to revenue, to expenditure as well as to revenue, and if you wanted to build it in by these devices you could do so.

Now, I do not know. I am kind of skeptical about taking away the power to decide in the fairly short run from the hands of the legislature.

Mr. TURE. This is sort of a formula flexibility?

Mr. MAXWELL. It is formula flexibility but you could make your formula as tight or as loose as you wish, leaving a lot of discretion in the hands of the executive or in the hands of the legislature, or both if you wish.

You could on the other hand, make a formula which was extremely rigid. I would not be for that.

Mr. TURE. One of the points, an important point in this outline, I believe, is this notion that you build up tax reserves during a period of high prosperity.

Mr. MAXWELL. Yes, sir.

Mr. TURE. Has the thinking on this gone to the point of disposition of these reserves?

What would you do with surpluses as they come in?

Mr. MAXWELL. You should not keep it all idle. You could put it in short-term securities. In New York that has been done, I believe.

These tax reserves in New York are of fairly long standing. I

do not know when they started, but my guess is they started back in 1941.

They are still in existence. The Bird Commission merely recommended that they should be formalized far more rigorously than they are presently.

You can invest them in short-term securities which are liquid, and avoid any reasonable chance of loss.

You can put them in your own State short-term securities if you wish.

You can lend to various State agencies if you wish.

Mr. TURE. Would it be possible, in addition, to invest them in Federal Government securities?

Mr. MAXWELL. I don't know why they shouldn't buy Treasury bills if they wish. I think they would prefer to buy State short terms rather than Federal. There is no reason why they if they liked shouldn't put them into the Federal Treasury bills.

Mr. TURE. The second question on this outline refers to the scheduling of capital construction programs at the State and local level. As I recall, you have two factors that you want to take into account at this point: One is the timing of the actual amount of outlays that you would want to make; and, secondly, the way in which you would want to finance those outlays.

Mr. MAXWELL. Yes, sir.

Mr. TURE. How would you apply this in the present situation, which some folks consider to be just a little better than high prosperity. It is really a good strong boom in which, perhaps, any significant increase in the total amount of capital outlays for, say, school construction programs would contribute to the boom pressures. On the other hand, faced with an increasing necessity for providing these schools, what would the State authorities in control of this program be impelled to do?

Should they increase their outlays under circumstances like the present, or should they defer the outlays until some of the buoyancy goes out of the present boom, and increase them at that time, implicitly recognizing, I suppose, the need for schools, as far as their constituents are concerned, is not deferrable.

Mr. MAXWELL It is perfectly clear that some of these State and local needs are not deferrable in the opinion of citizens, no matter how you talk at them as an economist. They are going to build them and the need is perfectly clear, so therefore I would say that the best thing that you can hope for State governments and local governments to do in terms of this outline that I have prepared is to finance more of these improvements which they think they must have now in a period of, it seems to me, boom, finance them, pay as you go; instead of issuing bonds running for 20 years, 30 years, 15 years, as the law says they may, it seems to me it would be a desirable economic effect, a stabilizing effect if they financed them pay-as-you-go.

Mr. TURE. Suppose in any one State that had a plan of this sort in operation, that the reserves building up without reference to any increased amount of outlays for school program were X million dollars. Then if you decided during the boom conditions to increase your outlays, say, for schools, highways, or something of the sort, that would indicate that, to go along with this plan, you would want to increase the size of that reserve still more?

Mr. MAXWELL. The tax reserve is a different proposition, although this is sort of a second reserve. It seems to me you just ought to charge your schools that you construct now to your general fund budget, instead of as you are entitled, financing them by borrowing; instead of charging the New York Throughway to 20-, 30-, 40-year bonds—I don't know what they were, they were issued the other day, it seems to me a considerable portion ought to be put on the regular budget, in good boom times like the present.

Mr. TURE. That would obviously require some increase in the total amount of tax revenues if you didn't want the reserve to start shrinking.

Mr. MAXWELL. It would.

Mr. TURE. Mr. Shaw, has this sort of program that Professor Maxwell, outlined, been given serious consideration at the State level?

Mr. SHAW. I heartily subscribe to the program outlined by Professor Maxwell. That is, to set up reserves when revenue receipts are far in excess of the necessary expenditures for appropriations, and also to have your construction during periods of depression or unemployment.

There is, perhaps, a practical difficulty. In dealing with State legislatures, if you have a reserve fund that could be made available for current appropriations, there is always the tendency of those seeking increased appropriations to ask for those funds to be appropriated and spent.

Now, if that reserve fund could be so earmarked, set up by law to, so as to preclude the expenditure for current appropriations, I think it would be a fine idea.

Mr. MILLS. Senator Douglas, do you have further questions?

Senator DOUGLAS. No, sir.

Mr. MILLS. On behalf of the subcommittee, I want to thank each of you for your appearance today, and your papers filed as part of the compendium and your summaries also today and your help in the subcommittee's deliberations with respect to this problem.

Sometimes I guess it might be wondered why a study of tax policy for economic growth and stability might include a panel on the subject matter before the subcommittee this morning, but I think you gentlemen have very ably pointed out and made evident the reason why a study of State and local taxation should be a part of the overall study being conducted by this subcommittee.

We thank you very much.

The subcommittee will stand adjourned until 2 p. m.

(Whereupon, at 11:28 a. m., the subcommittee adjourned, to reconvene at 2 p. m., of the same day.)

AFTERNOON SESSION

The subcommittee met at 2 p. m., Hon. Wilbur D. Mills (chairman) presiding.

Present: Senator Paul H. Douglas.

Also present: Grover W. Ensley, staff director, and Norman B. Ture, staff economist.

Mr. MILLS. The subcommittee will come to order, please.

This afternoon's session of the Subcommittee on Tax Policy will be devoted to discussion of the economic impact of Federal estate and gift taxation.

As was announced this morning, our procedure is to hear from the panelists in the order in which their papers appear in the compendium Federal Tax Policy for Economic Growth and Stability.

At the start of each of these sessions, panelists will be given 5 minutes each to summarize their papers. We will hear from panelists without interruption.

Upon completion of the opening statements, the subcommittee will question the panelists for the balance of the session. I hope that this part of the session can be informal and that the members of the panel will participate and have an opportunity to comment on the papers presented by other panelists and on the subcommittee's questions.

Our first panelist this afterenoon is Mr. Louis Eisenstein of the law firm of Paul, Weiss, Rifkind, Wharton, and Garrison.

Mr. Eisenstein.

Mr. EISENSTEIN. My paper is concerned with what seems to be the outcast of our revenue system—the Federal estate tax. While this tax helps to support many lawyers, it does relatively little to support the Government. Hence it scarcely evokes any friendly interest in Congress, apart from the hostility which it normally arouses as a capital levy which is constitutionally excusable.

In my paper I have assumed the burden of discussing two basic questions which envelop the estate tax. First, what are the objectives which the estate tax is supposed to achieve? Second, how well does it perform the tasks which have been assigned to it?

The answer to the first question emerges from a study of history. Though history does not always speak lucidly to its survivors, here the message which it conveys is rather clear. The answer to the second question, I believe, is equally clear, though not everyone will deplore it as I do.

In order to resolve the first question I have rapidly traced the development of Federal death taxes from the close of the 18th century until the present. It is commonly assumed, in and out of Congress, that the objective of the Federal estate tax is the social control of wealth and not the production of revenue. My own research has led me to conclude that this general understanding is quite erroneous.

History reveals that the estate tax, like earlier Federal death taxes, has been primarily imposed for revenue. Undoubtedly the desire to level hereditary wealth has contributed to the development of the tax. And certainly those who have been animated by this purpose have spoken more eloquently and vigorously in behalf of the tax than those who have been interested in revenue.

But the fact remains that the growth of the tax has responded more to the stimulus of revenue than to persistent exhortations for the dismantling of estates. Historically speaking, Congress has viewed the estate tax as essentially a progressive levy designed to raise revenue from the well-to-do. The social objective has been secondary, despite the many efforts in that direction.

I now turn briefly to the second question, which focuses on the actual performance of the tax. At present the estate and gift taxes produce somewhat less than $1 billion a year, or only about 1.5 percent of the total annual revenue.

No matter how much the estate tax is strengthened, its contribution is bound to be relatively small. While the individual income tax is a

mass tax, the estate tax is a class tax. And so the revenue which it yields must inevitably suffer by comparison. Yet within its limitations the estate tax could easily do much better revenuewise. The tax evidently takes a mere 14 percent of total net assets reported on taxable returns.

In short, from a revenue standpoint there is much more taxable capacity than Congress has been willing to realize. By raising the rates and lowering the exemption, Congress could derive another $500 million from the estate and gift taxes—or as much as half of their current yield.

Needless to say, a tax is not entirely known by the rates which Congress may bravely enact. The amount which is paid depends on the base of the tax as well as its rates. The base of the estate tax has always been conspicuously defective, and since 1948 its inadequacies have steadily enlarged.

Perhaps the best known loophole is the skipping of tax over several generations via settlements in trust. For example, if $3 million, less estate taxes, passes outright from one generation to another—without any marital deduction—the total tax paid when the property reaches the great-grandchildren of the initial decedent is about $2.2 million. But if the property is placed in trust for the intervening issue, the total tax paid is only about $1.2 million. I have tried in vain to discover some sensible excuse for this discrimination between property owned outright and property held in trust. If we must discriminate, at the very least the discrimination should be reversed.

Other familiar leakages in the estate tax base—though by no means all—are the marital deduction, gifts in contemplation of death made more than 3 years before that event, and life insurance.

To illustrate, it is now possible to pass about $1 million of insurance to a wife and three children without paying any gift tax or estate tax. Obviously, the lawyers are no longer obliged to work too hard in attempting to avoid estate tax.

In terms of its social objective the estate tax again does poorly. Of course, the tax cuts down aggregates of hereditary wealth, and the heirs receive less than they would otherwise obtain. However, the tax is a far cry from a true leveler of wealth, if "leveling" means what it has generally meant—the appropriation of estates to the extent that they exceed a reasonable inheritance for the security of the decedent's immediate family.

For example, the rates still leave about $5 million in an estate of $10 million—even if we rashly assume that the decedent helplessly takes no advantage of the loopholes in the base.

I readily concur in ex-President Hoover's view that hereditary fortunes, as distinguished from reasonable inheritances, are alien to the assumptions of our economic system.

If we genuinely believe in a substantial equality of opportunity, then we should cheerfully desire an estate tax which truly levels. We cannot have one unless we also have the other.

What Andrew Carnegie said many years ago is no less true today—"Of all forms of taxation a steeply graduated death tax seems the wisest." In terms of social policy it is the most virtuous and the least harmful.

Mr. MILLS. Our next panelist is Prof. C. Lowell Harriss, associate professor of economics, Columbia University.

Professor Harriss.

Mr. HARRISS. Although it is impossible to measure, and perhaps even to identify completely, the economic effects of death and gift taxes, some tendencies are evident.

1. Unquestionably, these taxes have been reducing large fortunes. Despite many methods of avoidance, some big estates are taxed and heavily. Private holdings, and concentration, of wealth are less than if these taxes had not existed. Almost $1 billion is taken each year from persons in the upper wealth group.

2. As part of a whole tax system these levies have important effects. They add, albeit crudely, elements of progression in a tax system predominantly proportional or regressive. Probably no other tax bears so lightly per dollar of revenue on lowest income groups. These taxes reach owners of types of property that generally escape some income tax—capital gains not realized before death, owners of municipal bonds, and wealth accumulated from receipts not fully taxed under the income tax, such as depletion allowances which exceed the owner's investment. The Federal credit for State death tax enhances the effective power of States to tax transfers at death by reducing interstate competition (though the amount of the credit is not necessarily to the best interests of the States). The gift tax helps protect revenue from not only death but also income taxes.

3. Present estate and gift taxes create great inducements to put property into trust. The economic effects of the trustification of property may be hard to judge—less waste by foolish investment and extravagant living is probably to the good; the conservative use of property in trust, on the other hand, tends to withdraw it from any possible use to finance new ventures. My own choice would be against special inducements for trustification of large fortunes, perhaps any big enough to be affected materially by present death and gift taxes.

4. In their present form the taxes encourage (*a*) inter vivos giving and (*b*) distribution of more property to the surviving spouse than would otherwise be the case.

5. The estate tax creates strong inducements to get an estate liquid before death. The difficulties that may result from lack of liquidity at time of death are perhaps exaggerated considering the extensions which the Treasury will grant. Yet the tax must be paid in cash. Owners of estates with large proportions of equity in closely held businesses, real estate, or such special property as art collections—and others whose reasons are mixed—commonly seek to convert such wealth to more liquid forms before death. Yet some of the most productive uses of property involve commitments which are relatively illiquid—notably equity investment in the new, pioneering venture. The somewhat adverse effects of death taxes in diverting wealth into more established firms could be reduced by well-publicized liberalization of payment requirements, involving no appreciable revenue loss.

6. The net effects of death and gift taxes on transfers to philanthropic and other nonprofit organizations cannot be determined. However, there can be no doubt that bequests to such institutions are much larger than if deductibility were not permitted.

The major opportunities for improving the present death and gift taxes require substantial "tightening" of the tax base. There is now,

it seems to me, too much economic power passing untaxed. I should suggest that rates in the upper brackets be reduced with the reduction used to obtain a more comprehensive definition of the tax base—if such a "bargain" were possible.

Mr. MILLS. First, I want to thank each of you. I want to thank the other two panelists scheduled for appearance this afternoon for the very excellent papers which they filed in the compendium. I want to thank you two gentlemen for your appearance this afternoon, and your summary papers. I appreciate you could take time off from your busy lives and important functions to be here with us.

As I have said in each of our sessions, our purpose is to find the important economic considerations which should guide the Congress in formulating tax policy for economic growth and stability.

In turning this afternoon to estate and gift taxation we must recognize, at least I think, that its importance with respect to the question of short-run stabilization is not very great. As a factor affecting long-run economic growth, however, it may well be of considerably greater significance.

Do you gentlemen agree with those conclusions with respect to the estate and gift tax?

Mr. HARRISS. Yes, sir.

Mr. EISENSTEIN. I would agree generally.

Mr. MILLS. It is a very general statement.

Mr. EISENSTEIN. It is a very large question. What I started out to say was that perhaps we should fill in some of the details of that broad conclusion.

I would agree with you that the estate tax, for example, does not remotely compare with the income tax as a fiscal instrument for economic growth, whether in the short run or the long run. But, by the same token, I feel that we can have a very good estate tax without worrying too much about its economic consequences, and I think that is an important point to make.

I would like to examine this conclusion briefly in terms of three considerations: (1) The economic motivations which permeate our economic system; (2) an adequate supply of investment capital; and (3) the social environment in which our economy must operate.

Now, insofar as economic motivations are concerned, as this committee is undoubtedly aware, the estate tax has often been charged with discouraging initiative and incentive. But in my opinion this is one of those observations which is frequently made but has never been proven.

I for one haven't noticed that Americans have become particularly lazy or listless because the estate-tax rates today are much higher than they were in the late twenties, when the top rate was only 20 percent, after Secretary Mellon got through his rate changes. I still feel that people are just as ambitious today as they were in the late twenties. They want to live well regardless of what happens after death, and are not particularly troubled by what happens after death.

I am not saying that there aren't people who are affected by those motivations but I think those motivations are rather small. One could argue in fact that a very effective estate tax can stimulate the incentive to work and produce, because the estate tax would deprive heirs of

property and those same heirs might otherwise be disinclined to work if they had these huge inheritances which the estate tax takes away.

In this connection, I think I might quote something which Mr. De Vegh, who I gather is an investment banker, has said about the estate tax. He says that in the absence of estate taxes "many old businesses went to seed because control remained with incapable descendants."

In other words, he is arguing that the estate tax has the beneficial effect of producing a turnover in business. As a result, many enterprises which would fall into incapable hands pass into more capable hands, which can better run the business.

Finally, I should add that there are enough income-tax incentives for those whose incentives might otherwise lag because of the estate tax. I might mention, for example, capital gains and percentage depletion.

Now I come to the second factor—the formation of adequate investment capital in this country. It is argued by organizations like the American Bar Association that estate taxes destroy the capital which is available for savings. Here, too, I think, we run across an observation which doesn't say very much, even though it is said very often. Any tax which Congress imposes will take money which would either be spent or be saved. The real question is whether it takes too much, so that the economy is hurt.

Now, it seems enough to say that the estate tax, which together with the gift tax takes only about a billion dollars a year, is hardly an impediment to the formation of adequate capital in this country.

In 1954 Senator Douglas pointed out—I believe on the floor of the Senate—that in the prior 8 years more was invested in productive capacity than in any prior comparable period, and he indicated that it was the greatest expansion in our economic history.

In other words, in a period of the highest peacetime rates, the United States had the highest level of capital formation.

Moreover, I believe that the function of individual savings in our economy is grossly exaggerated. Accordingly to Professor Berle, who has looked into this matter, in the 8 years 1946–52, about $150 billion was spent in the United States for plant and equipment. Of this staggering total, 64 percent, or $99 billion, came from internal sources—retained earning and reserve in the corporations—and only 6 percent, or $9 billion, was attributable to the issuance of stock. Of this amount, $9 billion, he says that probably not more than $5 billion, or less than $1 billion a year, represented risk capital or common stock.

I would now like to say a few words about what I consider the most significant positive contribution which a good estate tax can make to our economy. I believe that the health of any economy is intimately entwined with the social environment in which it operates. If there is a wide gulf, a wide discrepancy between different economic groups, the result is a very deep-rooted instability in the economic system.

Furthermore, hereditary wealth makes for social stratification and the social ills which it inevitably breeds. In my view, the estate tax can do a good deal here. It can't do everything, by any means, but it can do a good deal to give you a better social structure within which your economic system can operate, and I think that is the most important consideration to keep in mind.

Mr. MILLS. Professor Harriss, do you have any comment you desire to make at this point?

Mr. HARRISS. I think I would prefer to wait and answer questions as they come.

Mr. MILLS. Mr. Eisenstein, I gather from your paper in the compendium that you feel that if the estate and gift taxes were more effectively used as revenue devices in the Federal tax system, we would be able to place less emphasis on other forms of taxation which may be more deterrent to economic growth.

Did I properly interpret that?

Mr. EISENSTEIN. I think what I said was this: that if Congress, for example, feels that the upper income-tax rates are too high, and at the same time would prefer not to lose the revenue which would be lost if you reduced those rates, then I say you could reduce those rates and compensate for that loss of revenue by making your estate tax more effective.

I am not at all convinced in my own mind at this point that those income-tax rates should be reduced.

Mr. MILLS. Professor Harriss, do you feel that this interpretation of his view, or his statement in supplementation of the interpretation, places the estate and gift tax in proper perspective?

Mr. HARRISS. Yes; I think so in general. I am inclined to think that the role of private saving in capital formation may be more important than Mr. Eisenstein thinks. I do not believe, however, that the estate and gift tax impinge seriously upon the total of privately financed capital formation, but the type of investment may be affected. As regards the stimulation of a more equalitarian climate, estate and gift taxes seem to me to serve a useful purpose.

Mr. MILLS. We constantly hear the charge that the Federal estate and gift taxes by breaking up capital accumulations, serve to limit economic growth. You may not agree with that but I think you are aware of the fact that that statement is made at times with respect to the present estate and gift taxes.

In other words, it is argued that the breaking up of an estate impelled by tax requirements may make it more difficult for the succeeding owners to use the inherited property as effectively as it was formerly used.

What do you think of this charge against the existing system?

Mr. HARRISS. I think there is no question but that will happen in some cases; notably the closely held business.

Mr. MILLS. That is family-type operations?

Mr. HARRISS. Yes. The general line of solution that I would suggest would be, on the one hand, easing of the payment, the liquidity, problem of such businesses and on the other hand improving the financial mechanism generally to make it easier for such businesses to draw upon the general capital markets.

Mr. MILLS. What you say is true and it is particularly true with respect to the family-owned operation. Then would we be placing a further deterrent to the growth of these smaller businesses—because that is what they are, these family-owned businesses?

Mr. HARRISS. To some extent, certainly.

Mr. MILLS. If we exact a greater amount of tax from the estate on death.

Mr. Harriss. That is true. There would be such cases, but I doubt that there would be many.

Mr. Eisenstein. I don't think you destroy the business by an estate tax. What the estate tax does is shift the ownership of the business into other hands but the business is still there and continues to function.

Mr. Mills. But if you make it less possible for that business to function as a result of the Federal tax, then are you making it less likely that that business can succeed in new ownership or under new ownership?

Mr. Eisenstein. That is where I am not clear. It isn't clear to me that the estate tax has had that effect. It seems to me that the estate tax today has either 1 of 2 effects with respect to the closely held business. First, it may shift ownership to another family or to another economic group, and I don't think that result is necessarily bad. Perhaps the estate tax is designed to do that and we ought to face up to that problem.

Secondly, the other effect is that under legislation which was enacted by Congress in 1950, and which has been improved since that time, the estate is now able to pay the estate tax from corporate earnings without incurring any tax on the distribution as a dividend. I believe that very few estates have any problem today.

If they have enough earnings in the business they can pay the estate tax, and the same people continue to own the business.

Mr. Mills. The problem as I see it, or one of the problems at least of small business today, is this trend, if there is a trend, and some of the panelists have said there is an increase or a trend, in the direction of merger; liquidation of one unit by merger with another unit.

Now, if there isn't liquidity in the business at death of the originator of the business, then the tax take might well create a situation, could it not, where that business might find it difficult to continue as a separate unit, and might of necessity be forced into merger in order for the legatees of the estate to derive any benefit at all from the estate.

In other words, if they continue to try to operate under the burden of the tax without capital, they may well go into bankruptcy, so an inducement is afforded to sell the business or merge or to liquidate it through sale entirely. Isn't that happening to some extent and wouldn't it be more likely to happen if we increase the rates of the estate tax, or at least the take?

Mr. Eisenstein. I have heard there is some trend in that direction, but I must confess that I haven't run across those cases. The cases which I have individually seen have been cases where there were ample corporate earnings to pay the estate tax.

Also, it seems to me that a period of 10 years in which to pay the estate tax affords ample opportunity to pay the tax without too great a burden.

I don't mean to say that the present 10-year period could not be improved. I go along heartily with Professor Harris that we might liberalize that provision, but I don't think it is a very pressing problem now, frankly, on the basis of my own experience and on the basis of what I have read and the cases which I have seen.

Mr. MILLS. On the basis of that experience and the cases you have seen, does it occur to you that these taxes reduce the amount of profit in private hands; that is in the aggregate, present tax rates?

Mr. EISENSTEIN. I would say that the tax money is taken out of certain private hands and is used by the Government. It then finds its way into the hands of other private individuals.

There is no destruction of capital. That is the point I would like to emphasize. There is really a shift in ownership.

Mr. MILLS. Is it a shift, though, from private to public operation?

Mr. EISENSTEIN. I think in the usual case what happens is that the Federal Government of course collects estate tax; the family still controls the business because they are able to pay the tax out of internal earnings; and the Government then uses the tax money for various purposes, which may, for example, increase purchasing power, or on the other hand, increase plant and equipment.

Mr. MILLS. Does all of that result in inefficient use of resources?

Mr. EISENSTEIN. No. I think history shows the opposite because our economy is better than it was in the twenties. Secretary Mellon emphasized that we must reduce income and estate taxes in order to save the economy, and after he got through his tax reduction in the middle twenties we had the worst depression. Since that time our economy has been in high gear and we have had high-tax rates, so I think history disproves that theory.

Mr. MILLS. Mr. Eisenstein, I was quite impressed with your conclusion that actually the estate and gift tax was developed initially as a revenue device. I certainly am of that opinion, as I am likewise of that opinion with respect to most, if not all provisions of taxation that develop revenue to the Government.

In your consideration of the estate and gift tax from the point of view of increasing revenue, and improving its fairness, I presume, how can we revise existing law without increasing whatever deterrent effect these taxes may have on economic growth?

Mr. EISENSTEIN. There is one area in which I think I can speak with some confidence, and that is the loophole by way of trust arrangements. It seems to me that if we want to stimulate initiative and incentive, then we certainly should not discriminate taxwise against property which passes outright as compared with property which is held in trust. It is basically with respect to that sort of property—that is, property held in trust—that you have conservatism, timidity, and a refusal to go ahead with any fresh ideas. If we are really interested in using the estate tax to stimulate the economy, we should alter the present discrimination in favor of trusts and similar devices which enable the skipping of estate tax for several generations.

Mr. MILLS. Do you consider the use of trust arrangements to be a device to avoid the payment of the estate tax?

Mr. EISENSTEIN. Historically trusts were not designed to avoid estate tax any more than community property was designed to avoid estate tax, but there is no doubt that today they are the principal mechanism for avoiding estate tax.

I am not saying that trusts, per se, are some insidious institution that the tax lawyers have developed. I am simply saying that I have no objection to the use of trusts, but if people do use trusts, they should pay the same estate tax as is paid by those who make outright transfers. That is my position.

Mr. MILLS. Do you have anything to say on this point Professor Harriss?

Mr. HARRISS. On this particular point, or the general line?

Mr. MILLS. The general line.

Mr. HARRISS. I am inclined to take somewhat more seriously the problem of the closely held business, especially if death taxes were as heavy as I would like to see them, if the loopholes were closed, and so forth. There are bound to be some hard cases. Yet I do not think that the whole estate tax policy should be designed to avoid what would be a relatively small number of cases, really hard cases, I think the approach should be not the emasculating of the estate taxes but through improving capital markets that will make funds available to the closely held business either in debt or equity form. For example, the RFC or some institution of that sort might well have been used in the extreme cases. Personally, I do not think it is wise public policy even to encourage closely held businesses to tie up profits in liquid form, awaiting the death of the owner. Most other uses of property now are much more productive. The present estate tax gives a distoring effect which seems to me undesirable, though small. No one knows whether the number of cases involved is 50 or 500 a year. Certainly, it is not a major problem for the economy, and it is one that could easily be reduced.

On your question about the estate tax and capital formation and preservation, it seems to me that we must look rather more broadly. If the estate tax did not exist, what would happen to Government expenditure programs or to other revenue programs? The Government may use estate-tax revenues for consumption purposes and thus in a sense consume capital; on the other hand, the Federal Government is a big accumulator of capital, a builder of capital projects, some financed out of income and consumption taxes. I see no way of separating out the purely death tax aspects of the problems. Unquestionably, however, personal private capital accumulations are reduced more by estate taxes than consumption taxes.

Mr. MILLS. Mr. Eisenstein, what other opportunity exists under present law for the avoidance of the estate tax than the creation of trusts?

Mr. EISENSTEIN. Well, I would say that another leading mechanism for the avoidance of tax is life insurance.

Mr. MILLS. Since the enactment of the 1954 code.

Mr. EISENSTEIN. Yes, which abolished the premium payment test, and I have no doubt that a good deal of insurance is now being sold in the upper brackets because of that loophole in the estate-tax base.

Mr. MILLS. How else may the tax be avoided?

Mr. EISENSTEIN. Well, the tax may also be avoided today through gifts, particularly gifts in contemplation of death. For example, it has long been settled in the law that if you make a gift in contemplation of death, it is includible in the gross estate.

Almost every estate-tax law since about 1890 has had that provision as a simple protective mechanism to protect the tax.

Now, the law in effect provides you can make a gift in contemplation of death. Your avowed purpose——

Mr. MILLS. Since the code of 1954?

Mr. EISENSTEIN. No; I think a change came into the law earlier.

Mr. MILLS. In 1949.

Mr. EISENSTEIN. I don't believe we can blame everything on the 1954 code, although the tax lawyers frequently do so.

Mr. MILLS. I want the record to indicate clearly that is not the trouble with the 1954 code. That actually happened in 1949, I believe.

Mr. EISENSTEIN. No. I think Representative Knutson——

Senator DOUGLAS. The same group put through the 1948 as put through the 1954 code, though.

Mr. MILLS. I am not defending any group.

Senator DOUGLAS. I mean is it not true that the Republican Party was in control of the Congress in 1948 and also in 1954?

Mr. EISENSTEIN. That is true, Senator, but I don't think that loophole crept in in 1948.

Mr. MILLS. Was it before 1948?

Mr. EISENSTEIN. No.

Senator DOUGLAS. The Republican Party is not free—the Democratic Party is not free from sin in this regard.

Mr. MILLS. I think it must have been the Technical Changes Act in 1951.

Mr. EISENSTEIN. I am not sure whether it was 1950 or 1951.

The way the law reads now, you can proclaim to the world that you are making the transfer for the specific purpose of avoiding the estate tax. You have no other motivation. If you live a day longer than 3 years, it is perfectly all right, and the gift isn't includible in the estate.

Senator DOUGLAS. Doesn't this have the effect of making the heirs very much interested in prolonging the life of the parents after the gift has been made—at least 3 years?

Mr. EISENSTEIN. I suppose that is true, and to that extent the law serves some public policy.

Mr. MILLS. Are there other devices that might be used?

Mr. EISENSTEIN. Another device, of course, is gifts in general. That is, there is quite a disparity in the tax burden borne by transfers, depending upon whether transfers are made during life or at death. I tried to outline that in my paper. That kind of discrepancy has always existed in the estate-tax law since 1916. As I recall, around 1945 or 1946 the Treasury proposed a fairly good solution for that problem by way of integrating the gift taxes, but it is my impression that Congress has never been particularly interested in that solution. I think only integration would solve that problem, unless we are to abandon the estate tax and go over to some other form of death tax altogether.

Mr. MILLS. Are there any other devices or means that come to your mind?

Mr. EISENSTEIN. Another device or means is the marital deduction, but here I would like to be very refined in my conclusion. I am not saying that we shouldn't have a marital deduction. What I am saying is that the way the marital deduction works now, you are giving a tax bonanza not only to the surviving spouse, but also to the children. In other words, the amount the children ultimately take depends upon whether or not the husband, for example, leaves a wife, and whether or not, in addition to leaving a wife, he takes the marital deduction.

In my view the amount of estate that ultimately passes to the chil-

dren after estate tax should be exactly the same, regardless of whether or not the widow has been taken care of by the marital deduction.

Mr. MILLS. Now, I guess when you conceive that a trust can be used as a device to avoid the full inheritance tax, you include in your thinking with respect to trusts a provision of section 2039 (c), do you not, with respect to annuities and exemption of annuities under certain trusts and plans?

Mr. EISENSTEIN. I would be opposed to that. I think that is a loophole. I didn't go into that because I wanted to discuss primarily the basic loopholes, and frankly my paper was getting too long. But I seriously believe that that is an inexcusable loophole.

It makes no sense to me. I suppose the argument has been that since we have special income-tax treatment for pension trusts, we ought to have estate-tax benefits, too.

I don't see the comparison. In the income-tax field what you are doing is deferring the tax, but you still impose an income tax at some point. Here what Congress has done in the estate-tax field is to give a complete immunity for certain property interests which pass to members of the family, just like real estate, stock, or anything else.

Mr. MILLS. You are acquainted with what section 2039 (c) does. I know you are.

Mr. EISENSTEIN. Yes.

Mr. MILLS. Give us an example, for purposes of the record, of how it is a loophole.

Mr. EISENSTEIN. Well, as I recall, the provision, if an executive is a beneficiary of a qualified pension trust and let us say $200,000 is payable after his death to beneficiaries whom he may designate, and that $200,000 is attributable to contributions made by the employer to the pension trust, then that $200,000 is free from estate tax. That is my recollection. I am still very weak on section numbers.

Mr. MILLS. During the time when the premium was paid, is the premium included in the employee's income for tax purposes?

Mr. EISENSTEIN. No; it is not, as I recall.

Mr. MILLS. Are there other devices that come to your mind that you have not commented on to this point? Incidentally, when was that written into the law?

Mr. EISENSTEIN. The last provision that we discussed?

Mr. MILLS. Yes.

Mr. EISENSTEIN. That came into the law in 1954.

Mr. MILLS. Are there any other devices?

Mr. EISENSTEIN. I can't think of any other significant loopholes. I am sure there are little fringe loopholes here and there that lawyers always uncover somehow, but I cannot think of any really basic loopholes.

Mr. MILLS. Just for the record, I do not think you have called attention yet to even all the significant ones.

Mr. EISENSTEIN. One just occurred to me, as a matter of fact. I think the gift-tax exclusion is much too large. The original purpose of the exclusion was to enable a donor to make Christmas gifts, wedding gifts, and similar presents, without having to report them, and without running afoul of the gift-tax penalties if he failed to report them.

What has happened is that the gift-tax exclusion is now a very important device in how to beat the estate tax.

It is an instrument in estate planning. It is now $3,000 annually, per donee, and in the case of a married donor, it is actually $6,000 a year.

In other words, if you have 4 children, and let us say, 8 grandchildren, you can give $6,000 to each 1 of them, without paying any gift tax.

Mr. HARRISS. Each year.

Mr. EISENSTEIN. Each year. It is an annual loophole.

Mr. MILLS. Do any other devices come to your mind, Professor Harriss?

Mr. HARRISS. Not offhand. There is the minor matter of real estate outside of the United States but I do not think that is particularly significant. I do not know whether you would call philanthropic contributions a loophole or not.

Mr. EISENSTEIN. We have stayed away from charitable foundations. I suppose that is one of the really important problems, but I think it is a problem in itself.

I have a feeling we just do not know enough about the foundations, particularly in the estate-tax field, to come to any conclusion.

Mr. MILLS. Senator Douglas?

Senator DOUGLAS. I would like to ask if either of the witnesses have made any estimates as to the amount of revenue which is lost annually by each of the so-called loopholes, or acts of erosion, assuming present rates.

Mr. EISENSTEIN. Well, I have not made any study. All I can do is give you 1 or 2 figures that occur to me. I recall that when the marital deduction was enacted in 1948 the Treasury stated that the revenue lost at that time would be about $250 million, but that is not a complete figure because the Treasury failed to take into account the estate tax which would be payable when the second spouse died.

They simply took into account the revenue lost immediately on the death of the first spouse, and I think the revenue lost would be less than $250 million.

Senator DOUGLAS. But, of course, the national wealth has increased since 1948.

Mr. EISENSTEIN. That is correct.

That estimate, of course, would be larger now.

In 1950 the Treasury requested changes in rates and exemption, in order to compensate for that loss and they estimated in that year that the loss was about $300 million.

Senator DOUGLAS. On the marital deduction?

Mr. EISENSTEIN. They said those changes would compensate for the revenue lost by means of the marital deduction.

Again I want to emphasize that that $300 million is not really a true figure, because part of the revenue lost when the husband dies is made up when the wife later dies.

Senator DOUGLAS. Do you have any estimate as to the loss of revenue because of the exemption of gifts made more than 3 years prior to death?

Mr. EISENSTEIN. No; I have no idea.

Senator DOUGLAS. Or the amount lost through the trust provision?

Mr. EISENSTEIN. I have no idea.

Senator DOUGLAS. Or the insurance provision?

Mr. EISENSTEIN. The estimate I believe I saw in the committee reports when the provision went through was $25 million.

Senator DOUGLAS. $50 million?

Mr. EISENSTEIN. $50 million, although I thought it was $25 million. I think that is on the conservative side.

Senator DOUGLAS. Mr. Harriss, would you roughly agree with this?

Mr. HARRISS. I had occasion last fall to try to estimate the so-called erosion of the estate-tax base, and I gave it up as completely impossible with any figures that are available. But I am sure that it is very substantial in terms of present revenue.

Senator DOUGLAS. Someone I know used the estimated from $300 million to $500 million.

Mr. HARRISS. I think that is much too low.

Senator DOUGLAS. You think that is much too low?

Mr. HARRISS. I should think so.

Senator DOUGLAS. You think it is more than $500 million lost through these so-called loopholes?

Mr. HARRISS. I think so; yes.

Senator DOUGLAS. Mr. Eisenstein?

Mr. EISENSTEIN. I would think it is at least half a billion dollars. How much above that I have no idea, frankly.

Mr. MILLS. It is a growing thing.

Mr. EISENSTEIN. That is right. It grows. Of course you could not make up the entire loss immediately, even if something were done about these loopholes, because if prior legislation is any precedent, the existing trust arrangements, for example, would not be covered by the new legislation.

Very likely a good deal of the insurance which has been purchased in the recent period since the enactment of the 1954 Code would not be covered, and I am sure you would have similar problems of retroactivity with respect to the other loopholes.

Senator DOUGLAS. The chairman mentioned another possible loophole, the exact nature of which I was not quite certain at the time, but about which you testified.

Do you have any estimates there as to loss of revenue, form the annuity provision?

Mr. EISENSTEIN. I have no estimates other than those two which I mentioned very generally.

Mr. MILLS. If you will pardon me, there is really no way to estimate the revenue effect of a provision like that early in its operation. It will lose more revenue if more people are sold on the idea of leaving estates through this device.

If they do not accept it as a method of leaving estates then of course the revenue effects would be smaller, but while I have the panel may I suggest another possibility?

Senator DOUGLAS. Surely.

Mr. EISENSTEIN. Yes, sir.

Mr. MILLS. Mr. Eisenstein, is the use of a life estate a possible device for avoidance of the full impact of the estate tax?

Mr. EISENSTEIN. The life estate is used in connection with trusts.

Mr. MILLS. You considered that then in connection with the trust?

Mr. EISENSTEIN. I think that is the most serious loophole today, in my opinion.

The Treasury study which was made in 1950 indicated that, of the high-bracket decedents, 45 percent of the gross transfers was in trust.

Mr. MILLS. I think as a matter of the record you and I would not want to stand that it is only used in connection with trusts.

Mr. EISENSTEIN. Not at all. But is is frequently motivated exclusively by estate taxes.

Senator DOUGLAS. I would like to develop the history of trusts if I may.

As I understand it, they began to come in on a large scale in Massachusetts around, after the Civil War, when the original families which had acquired fortunes began to distrust the ability of their children to administer those fortunes with acumen.

Mr. EISENSTEIN. They were called "spendthrift" trusts.

Senator DOUGLAS. That is right.

That was the name for the Massachusetts fortunes which set up trusteeships which retire the sons from active lives of business and consigned them to birdwatching and membership in various philanthropic societies, which I believe Mr. John P. Marquand has mentioned in his novels and which finds confirmation in the reports of Mr. Cleveland Amory on proper Bostonians, Mr. Amory being a proper Bostonian, himself.

Would you roughly agree with this analysis?

Mr. EISENSTEIN. I think I would, historically speaking, although of course the history of the trust dates back well into the Middle Ages in England.

Senator DOUGLAS. A good many people have said that the effect in Massachusetts has been very unfortunate in that it has removed from the rough stream of life, men of ability who, if they had stood on their feet, would have been active participants instead of decorative adornments to society.

Do you have any judgment on that?

Mr. EISENSTEIN. I do not think I could put it any better than you just put it, and I heartily agree.

Senator DOUGLAS. Therefore to the degree that the creation of trusts has been given an added incentive by the inheritance-tax laws, the social effect is unfortunate.

Mr. EISENSTEIN. That is correct.

That is precisely my position.

Senator DOUGLAS. I find myself in hearty agreement with you.

It has been a misfortune to Massachusetts that this has happened, and the significance of Mr. Marquand's novels and Mr. Avery's comments are not always realized by students of taxation.

As you may have inferred I favor a principle of progressive inheritance tax. I think the erosion of the base and creation of loopholes has been unfortunate.

One feature has always worried me. I think it is proper to bring this fear out into the open so that it may be grappled with, and that is that a Federal tax or any tax on inheritances when realized requires the sale of a capital asset.

Now the money realized from this capital asset will be spent on the usual run of governmental expenditures, which, on the whole, are much weighted on the side of consumption expenditures rather than captial accumulation.

Does not this have an effect, therefore, of transferring purchasing power from the maintenance of capital equipment into the financing of current consumption expenditures, and therefore I think this is what Congressman Mills may have asked in his earlier question, therefore does it not shrink the productive base of society, or at least prevent it from growing as it otherwise would if there were not such a tax?

This, frankly, is the one doubt that I have.

Mr. EISENSTEIN. But your doubt, as I gather it, would turn largely in terms of how the Government uses the money.

Senator DOUGLAS. Unfortunately.

Mr. EISENSTEIN. Not in terms of the tax itself.

Senator DOUGLAS. Unfortunately, the major part of governmental expenditures go for what might be termed "consumption expenditures," and I would include national defense in that category necessarily, but they do not add to the sum total of productive equipment of society.

Mr. EISENSTEIN. I think we should keep in mind that the estate tax is not unique in that respect—the income tax in the upper brackets does exactly the same.

Senator DOUGLAS. It may, but, of course, the income tax may simply largely divert expenditures from luxuries into public expenditures.

Mr. EISENSTEIN. That is true.

Senator DOUGLAS. This will require the liquidation of capital assets.

Mr. EISENSTEIN. Well, I would agree with you that in the case of the income tax the impact may be a little different, because the person who pays the tax may either cut down his consumption or he may cut down investment, whereas in the estate tax you probably don't have a similar situation. On the other hand, I still feel that the amount taken by the estate tax is so small that there just isn't enough to worry about.

Senator DOUGLAS. If we plug these loopholes, might it not be much larger?

Mr. EISENSTEIN. All right. This seems to me to be the answer then: if you are worried about that, and you do want a good estate tax, then let's have a good estate tax and reduce the income-tax rates.

Senator DOUGLAS. The upper brackets?

Mr. EISENSTEIN. That is right.

Senator DOUGLAS. Professor Harriss?

Mr. HARRISS. Unquestionably there is something to the concern about the effect of high death taxes upon privately owned capital. The basic problem is inevitably serious only in the case of the business firm that does not really have access to capital markets—effective capital markets. In such cases, there is a depletion of the funds available for the business which cannot be made up adequately in some other way.

Senator DOUGLAS. But even in the case of holdings in corporations whose securities are freely traded in, the liquidation of these holdings to pay a Federal estate tax would mean there they are purchased by other private individuals.

Mr. HARRISS. That is right.

Senator DOUGLAS. These private individuals would not be able to make the new investments.

Mr. HARRISS. That is quite true.

Senator DOUGLAS. Which otherwise would be made, so that you diminish the rate of growth in other sectors, and convert the capital asset into an income stream which is spent for present purposes.

Mr. HARRISS. Generally true, but not, I think a serious problem. The net reduction in capital formation, compared with the reduction under a system using, say, consumption taxes is very small as a part of the total of capital formation. This country has enough income to build capital out of new savings while still drawing on some past savings for supporting Government.

Mr. EISENSTEIN. I would add to that if it is a serious problem, you can arrive in effect at the same solution by reducing your income-tax brackets in the upper areas.

May I in this connection read a quotation from Mr. De Vegh, who has given a good deal of attention to the estate tax. He says, "large fortunes are not built on savings. Nobody gets rich by saving 10 percent of his salary. Large fortunes are built by the acquisition at low cost of property, which, as a result of good judgment, good luck, or good management, eventually becomes very valuable."

And I think you will find that many of the phenomenal firms in the last few years really have been built on very little outlay, and I think it was good for the economy. I think if those same people had inherited money, they probably would have been social drones.

Senator DOUGLAS. Now, this last point that you mentioned reminds me of a book which I read at least 30 years ago by an Italian named Professor Rignano, who favored progressive taxation of inheritances over time. That is, that the inheritance of a given amount by a grandson would be taxed at a higher rate than inheritance by a son, and then inheritance by a great-grandson at a higher percentage than from a grandson, or perhaps, to put it more coarsely, second-degree inheritance be taxed at a higher rate than first-degree inheritance and third-degree inheritance taxed at a higher rate than second. That is, if the original bequest was for a million dollars, then the amount passed on would be taxed when the inheritor died. It would be taxed at a higher rate to those to whom he passed it on than he in turn had to pay, and so through time so that in the course of 3 or 4 generations one would not be able to live on inherited wealth, but would have to live on current income, or income accumulated by parents or at the most by grandparents, but not by great-grandparents.

That received some theoretical attention at the time. The chief British civil servant in the Inland Revenue Office in England was a highly conservative expert on public finance and wrote some articles supporting this, but so far as I know it has never been incorporated in any inheritance-tax law. What we have had has been an erosion, rather than expansion, of the base, and so forth, so therefore it may seem somewhat inappropriate to raise the issue.

I wonder if either of you have any opinion on the wisdom or practicability of this suggestion?

Mr. HARRISS. I have always been attracted to the idea. However, I think the practicability is open to serious question, in view of the fluidity of property arrangements under our law and the difficulty of keeping track and of tracing property. I have real doubts about feasibility.

Senator DOUGLAS. Of course, that was used as the great administrative difficulty, but I always thought that difficulty might be met if

instead of trying to trace individual amounts of property, you traced total sums, and you say given this amount, and if you fall below it——

Mr. EISENSTEIN. The Rignano plan has been mentioned on several occasions. I remember in 1937 the 20th century tax fund made an elaborate study of our Federal tax system and they suggested that Congress should look into the Rignano plan. The Rignano plan was really designed to overcome the objections of those who argued that the estate tax discourages incentive. Therefore, said Rignano, "Let us have two types of rates. We will tax at a lower rate those accumulations which are earned by the decedent himself, as distinguished from those which he inherits," but, as Professor Harriss points out, you do run into administrative difficulties when you try to draft a statute. I am not saying that the problems are insuperable. It is my impression that we probably could draft a statute if Congress really got interested in the scheme.

Senator DOUGLAS. Of course, I was much impressed with the quotations that you made in your major paper of the early advocates of progressive inheritance taxation, Andrew Carnegie, Theodore Roosevelt——

Mr. EISENSTEIN. I regret to say I couldn't add Secretary Mellon to that roster.

Senator DOUGLAS. And a number of others. My former teacher, Professor Seligman, who was himself a man of great wealth, but who favored this method, and who incidentally I think was one of the most public-spirited economists I have ever known. What seems to me to have happened has been a loss of enthusiasm for the principle, so that we have permitted these successive loopholes to be inserted with almost no public protest. Can you account for this? Has this been a sort of anesthetization of the social conscience in matters of taxation, or has it been that there have been so many problems thrown at the public that it is very difficult to keep one principle separated?

Mr. HARRISS. Even more than that has been the complexity of these things. I don't suppose one person out of a hundred thousand has any comprehension of what is happening.

Mr. EISENSTEIN. That is good for the lawyers.

Mr. HARRISS. Yes. In addition, people think we now really have a progressive estate tax; with lots of other things they have to worry about, they are not concerned about improving—getting, that is—what they think they have.

Mr. EISENSTEIN. I think what has happened to the estate tax is part of a broader pattern, which includes what has happened to the income tax. I don't think anything really substantial is going to be done about the estate tax until Congress really starts thinking about the situation with respect to the income tax, too.

Senator DOUGLAS. Of course, you know that Congress in the main reflects the national will. It can slightly precede the national will, but it cannot greatly precede the national will, and there must be a change in public thinking and an increase in public information before Congress as a practical matter will act.

Mr. EISENSTEIN. That is true, but one of your difficulties is that the rates look very high, but the loopholes are in the base, and the average man on the street has absolutely no notion how the tax base is designed. He may have some vague notion about the progressive

rate structure, and he may have the further vague notion that everybody is subject to that progressive rate structure. What he doesn't know, of course, is that the base withdraws a good deal of income and property from the progressive rate structure. In short, he is very poorly educated on the subject.

Mr. HARRISS. I would like to add that a relatively small group, with concerted power, can apparently exercise a great deal of influence, as witnessed by the nature of some of these loopholes.

Senator DOUGLAS. That is, of course, one of the great difficulties we have, that the diffused interests of the many is comparatively ineffective in face of the concentrated interest of the few.

Mr. EISENSTEIN. That is correct.

Senator DOUGLAS. That is one of the great difficulties in making any type of government work, and included among that the difficulties of making a democratic government work.

Mr. HARRISS. A look at economic textbooks, as they discuss this problem, might be revealing. Relatively few give any indication of the realities of, say, the income tax or the estate tax as regards their real effectiveness.

Senator DOUGLAS. In other words, people are allowed to believe that the progressive principal has swept the field in both income taxation and in estate taxation, whereas as a matter of fact so many escape clauses have been written in that it is very much more ineffective than it seems to be on the surface.

Mr. HARRISS. I think so.

Senator DOUGLAS. I hope you can enlighten us on this.

Mr. HARRISS. I have tried.

Mr. EISENSTEIN. As a matter of fact, Professor Harriss has a very good and detailed chapter on the estate tax in his book, which I have read.

Senator DOUGLAS. That is I think all, Mr. Chairman.

Mr. MILLS. We thank you two panelists for being with us today and helping us with our hearings.

This panel discussion concludes our schedule of hearings.

I want Senator Douglas' permission for all panelists who desire to do so, to include in the record supplemental statements in answers to questions or for purposes of further clarifying their own positions on any of the issues discussed.

I know of 1 or 2 who have already requested permission to do that.

Senator DOUGLAS. Yes, sir.

Mr. MILLS. And to include even other items that they think have a bearing upon what we are seeking here.

That request was with respect to panelists.

I question very seriously that we should grant permission to include papers by others than those who have been panelists for the reason that this is different type of hearing than that normally conducted.

We have been primarily interested in the view of those who have been asked to be here as panelists, and to submit papers for the compendium.

There might be some exception to that. I know on 1 or 2 occasions I have asked permission for letters addressed to me to be included as a part of this record, when individuals in certain industries have felt that the record did not clearly reflect all of the facts incident to that industry, and that it would be of benefit to the committee to

have their point of view expressed, but I know of no additional request and I suggest that we not leave it open for blanket inclusions.

I want to thank the members of the subcommittee for their fine cooperation, and their great patience and understanding of my limitations in the position of the chairman of the Subcommittee on Tax Policy.

Senator DOUGLAS. I might say the modesty on the part of the chairman is characteristic but ill-founded.

I have never seen a committee presided over more skillfully nor with greater intellectual distinction than that displayed by the gentleman from Arkansas during these hearings.

Mr. MILLS. Thank you, Senator Douglas. I want, at this time, to thank each and all of the panelists for the very fine papers that they have contributed to the compendium and for taking time off from their busy lives to be present, to answer questions propounded by members of the subcommittee, and to answer other papers or to comment on other papers of other panelists.

I know of no work that has been done by any group that I think merits any greater consideration than the work that has been done by members of these panels in connection with the compendium.

I want to thank all 81 or so of the panelists for the very fine job that they have done.

I want to thank the members of the staff of the Joint Committee on the Economic Report for the fine work that they have done in connection with the hearings and in the preparation of the compendium.

Without the members of the staff, I might say our job would have been made unbearable. They have greatly relieved us of responsibilities and part of the load.

Senator DOUGLAS. I want to join in that.

Mr. MILLS. Particularly, Mr. Ture, for the very fine work that you have done in connection with the hearings and the interrogation of witnesses, and Mr. Ensley, for the direction that you have given in your position with the staff.

If there is nothing more to be said——

Senator DOUGLAS. I do not think there is anything more to be said, Mr. Chairman, but I would like to say this: That I hope very much that we can get more copies, both of the green book, the so-called compendium of papers presented by the panelists, and of the source book that the staff has compiled printed than would normally be the case, and I hope that we may recommend to the full committee printing of several thousand more copies than we would otherwise be able to do.

I am ready to try to get this reprinted as a Senate document, if it is the will of the Subcommittee that this should be done, because I believe that is the most effective way, but it may be that since the House has had a larger share in developing these hearings than the Senate, that the House would prefer to have it as a House document rather than as a Senate document, and I think the chairman has more influence on the south side of the Capitol than I have on the north side of the Capitol.

I more we continue this discussion in executive session.

Mr. MILLS. The subcommitte now stands adjourned.

(Whereupon, at 3:20 p. m., the subcommittee was adjourned.)

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