TAX SUBSIDIES AND TAX REFORM

579

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TAX SUBSIDIES AND TAX REFORM

WEDNESDAY, JULY 19, 1972

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10:10 a.m., in room G-308, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire and Javits; and Representatives Reuss and Griffiths.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; John R. Karlik, Richard F. Kaufman, and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; Walter B. Laessig, minority counsel; and Leslie J. Bander, minority economist.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

The Federal tax system has deteriorated to the point that it represents one of the Nation's major economic problems. I am dismayed, however, by the way the tax reform debate has been characterized by a lack of hard facts and careful studies of the tax system.

Some reform advocates have promised more than they have thus far been able to substantiate.

The administration, on the other hand, acts as if there is nothing wrong with the tax structure.

Only by careful study and debate can we determine where the truth lies. Because it is such a complicated and far-reaching matter, now is the time for both Congress and the administration to be hard at work studying the subject. These hearings will endeavor to provide careful analysis and debate on the Federal individual and corporate income tax systems.

On the basis of previous testimony before the Joint Economic Committee, I think it is clear that the Federal individual and corporate income tax systems have developed the following deficiencies:

No. 1, because of the large scale injection of tax subsidies, the income tax laws have lost much of their revenue generating capacity. Over the last 10 years, special reductions of Federal income taxes have reduced annual full employment revenues by about $35 billion—or more than the very large deficit of last year.

No. 2, these same tax subsidies have shifted the tax burden away from the corporate and individual income tax systems to the more regressive payroll taxes. Individual income taxes, our most progressive

tax, dropped as a share of the total tax burden from about 46 percent in fiscal 1969 to an estimated 43 percent in fiscal 1973.

At the same time, corporate income taxes, which have some progressivity even though much of it may be shifted to consumers, dropped from 20 percent in 1969 to an estimated 16 percent in 1973.

Taken together, this represents about a 7-percent decrease in Federal individual and corporate taxes in only 4 years. During the same time regressive social insurance taxes rose from almost 21 to an estimated 29 precent, or approximately 8 percent.

And most of the tax subsidies benefits accrue to upper income families. In an earlier study done for the committee, for example, Mr. Joseph Pechman and Mr. Ben Okner found that 47 percent of the special tax provisions in the individual income tax system are received by 8 percent of the families with 25 percent of the total income.

No. 3, these tax subsidies have made paying taxes so complicated that our citizens cannot understand the system. Internal Revenue Service Commissioner Johnnie Walters has recently reported that about half of the nearly 80 million returns filed for 1971 were prepared commercially, and that many of those who go to commercial tax preparers are wage earners who are least able to afford it.

These deficiencies have, in my opinion, made the case for some form of tax reform in the near future. The issue now is how to go about tax reform: What provisions should be altered, and how, to what extent should we reform corporate versus individual taxes, and over what time period. In other words, what should be the Nation's plan for tax reform?

The Mills-Mansfield proposal to systematically review all these tax subsidies over a 3-year period is certainly a good first step. But we must prepare for that systematic review now by developing careful studies of the present economic effects of each special provision and, as important, the likely economic effects of removing or altering the provisions.

Prior to these hearings, the Joint Economic Committee published several new studies evaluating about $23 billion worth of Federal individual and corporate tax subsidies. This was done as part of our continuing review of Federal subsidies. These studies evaluated investment incentives, capital gains, tax-exempt municipal bonds, real estate incentives, tax subsidies to the timber industry, to the oil industry, and to the insurance industry.

Although the studies will no doubt be controversial—and in some cases we will need additional evaluation—these studies point the way to raising additional billions of Federal revenue while increasing the efficiency of our Federal tax system and its fairness. Our hearings today will continue to focus on developing information to assist the Congress in the "how" of tax reform.

As our first witness this morning, we are delighted to have the distinguished Congressman, Representative Charles A. Vanik, Democrat of Ohio.

Mr. Vanik, will you come forward and take your position at the microphone here?

Mr. Vanik has represented the Cleveland area of Ohio since 1954 in the House of Representatives. He is a graduate of the Western Reserve University School of Law. He has served as a member of the

Cleveland City Council and the Ohio State Senate, as a judge of the Ohio municipal court, and he has established himself as an outstanding expert on taxes in the Congress.

Mr. Vanik, go ahead. You are aware that you are constrained because you have so much information. You have done a marvelous job, I think, of assembling a great deal of data that has not been available before. I am embarrassed to have to apply the 10-minute rule, but that is a rule that we do apply, and maybe in the questioning period, you can bring out some points you didn't have a chance to bring out before.

Representative VANIK. Mr. Chairman, I wonder if I could have with me Mr. Vaughan, Mr. Talisman, and Mr. Pedley.

Chairman PROXMIRE. Certainly.

STATEMENT OF HON. CHARLES A. VANIK, A U.S. REPRESENTATIVE IN CONGRESS FROM THE 22D CONGRESSIONAL DISTRICT OF THE STATE OF OHIO, ACCOMPANIED BY JAMES K. PEDLEY, WILLIAM K. VAUGHAN, AND MARK E. TALISMAN, STAFF

Representative VANIK. Mr. Chairman, today's testimony is a follow-up to the presentation which I made before your committee on March 21st. At that time, I pointed out that an examination of several major corporate reports indicated that some corporations were making profits, paying dividends—yet paying no Federal corporate income tax. During my testimony, it was agreed to proceed with a formal, organized study of America's largest corporations and the level of Federal taxes which they paid.

Mr. Chairman, at this point, I would like to ask your permission to place into the record a complete tabulation of the findings that we have made in the prepared statement.

Chairman PROXMIRE. Without objection, the entire prepared statement will be printed in full in the record, including the very helpful tables and the other material, at the end of your oral statement.

Representative VANIK. The table in particular was in process about 5 months and I certainly would appreciate having it included.

A portion of this study is now completed. I believe that it provides valuable information on the questions of corporate tax policies, inequities, and distortions, created by some of the tax subsidies which have been enacted. These policies have a definite inter-enterprise effect between corporations as well as individuals.

My study examines 145 companies selected from the 1970 Fortune magazine lists of large corporations, and covers the years 1969, 1970, and 1971.

The study is based entirely on information available to the general public, including prospectuses filed with the Securities and Exchange Commission, as well as annual reports to shareholders.

I might say, Mr. Chairman, we have gone over some 1,400 annual reports.

It should be noted that the figures presented in the table represent approximations rather than precise figures. In a few isolated cases, the margin of error may be considerable. This is because the public sources generally did not present the data in a comprehensible form, resulting in deceptive reports that even a CPA can't decipher.

Corporate annual reports are a "mirage of ambiguous statements" that lead stockholders to believe that business is better and profits are improving. The tax statements of these same companies to Internal Revenue often illustrate a completely different picture that reduces their profit figure, which in effect, reduces their total tax figure. Like the medieval European peasants, for their stockholders they wear their wedding clothes; for the tax man, they wear rags.

Let me say here that I believe the figures in the tables are as accurate as they could be made by my staff, aided by expert certified public accountants. If there are errors, the fault probably lies in the unnecessary complexity used by corporations in submitting data which was designed to serve the public—but which is almost completely obscured from public scrutiny.

U.S. Steel, for example, combined their United States and foreign income taxes so that even after careful study, an informed citizen cannot tell who was paid what without calculations and careful work with footnotes. IBM, the fifth largest corporation in this land, combined their foreign and federal taxes in all public records, including their 10–K forms. Other companies which did the same include RCA, National Cash Register, and Colgate Palmolive.

These companies have disregarded SEC rules on disclosure. For commercial and industrial companies, SEC rule 5–04, 15 provision for income and excess profits taxes (requlations S–X, page 12) requires that: "(1) Federal income taxes (normal and surtax); (2) Federal excess profits tax; and (3) other income taxes—State, local, and foreign—be stated separately." Yet these companies—and many others—have combined all income taxes into one expense figure.

Just recently, we had a report from the petroleum industry in which they added to their taxes, paid out, all the excise taxes which were paid by the consumers who purchased their products. Now, that has certainly carried it to the extreme.

America's corporate giants may have been able to utilize the tax subsidies included in the Internal Revenue Code to obtain an effective tax rate lower than the average tax rate paid by all American corporations. Some of these corporate giants have managed to escape all Federal tax payments—despite the fact that they are earning substantial profits and paying out dividends.

Data was not available for all of the top 100 industrial corporations. In addition, the summary statistics did not include those few firms which had a loss.

In general, it appears that in any one year, about 10 percent of the Nation's top industrial corporations did not pay any Federal corporate tax on their taxable net income. In 1971, five out of the 45 corporations for which figures were available did not pay any Federal corporate tax on before tax income of $382 million. These companies were: Continental Oil; McDonnell Douglas; Gulf & Western Industries; Aluminum Company of America; and Signal Companies. In 1970, nine of 86 corporations did not pay any tax on $682 million in taxable income. In 1969, seven of 78 corporations did not pay any Federal corporate tax on over $862 million in taxable income.

By using proportions, it can be estimated that when the complete data for 1971 is available on all of the top 100 industrials, Federal corporate income tax avoidance may amount to $1.2 billion.

In addition, the study shows that about 10 to 15 percent of the top 100 industrials who earned profits generally pay a Federal corporate tax rate of less than 10 percent. For example, in 1970, 13 out of 86 corporations paid less than a 10-percent rate on almost $3.2 billion in taxable income.

I am sure that every American citizen will be shocked and disappointed at the way in which many of these corporations have avoided the statutory Federal tax requirements. I hope that the revelation of the fact that many corporations are completely or substantially escaping support of the Federal Government will cause all Americans to consider the need for tax reform—not just individual tax reform, but corporate tax reform as well.

Great public concern and indignation has been focused on those 107 Americans who received more than $200,000 in income last year yet paid no Federal income taxes. But put the facts in perspective: Those 107 Americans received a total of $26 million tax free. In 1970 nine corporations out of the top 86 had a pretax income of $682 million—yet paid no Federal taxes.

But this study has more to teach us than the fact that we need tax reform.

This study documents, in many ways, how the Federal tax system is encouraging the growth of monopolies, conglomerates, and supranational corporations. It reveals how many of the tax subsidies provided by the Congress have outlived their usefulness and are now creating severe problems of inequity and injustice between corporations—both within the same industries; and between different industries.

The average effective tax rate of all American corporations in 1969 was 37 percent. But the average tax rate for the top 100 industrial corporations which showed a profit in 1969 was 26.9 percent. This means that the smaller corporations appear to be paying a rate above the average. It is my estimate that the smaller corporations—those under the top 100—pay, on the average, a rate of 44 percent. Obviously the giant corporations enjoy greater cash flow, higher rates of return—and the economic power to acquire more and more subsidiaries—thus driving the smaller firms which pay higher rates of taxation out of business.

In 1969 profitable firms in the top 100 had an effective tax rate of 26.9 percent. By 1971 this figure was reduced to 24.4 percent. Let there be no doubt that the effective tax rate for the top 100 is headed for even further decline in the future because of the giveaway provisions of the 1971 Revenue Act.

The steel industry, particularly U.S. Steel has paid a low effective tax rate over the past 3 years. In 1970, U.S. Steel paid no Federal tax, received a credit or reduction of its tax liability of $66 million—yet had an income before taxes of $109 million.

Some oil giants have—in some years—paid high effective tax rates. Standard Oil of Ohio, for example, paid a 41.1 percent rate in 1969—and, apparently no tax in 1970. Out of the 17 oil companies studied, 10 paid less than 10 percent in 1969 and seven paid less than 10 percent in 1970.

The timber industry giants pay effective tax rates of between 10–20 percent on large pretax incomes.

Each of these industries is a horror story of tax avoidance. I have provided sections in my statement detailing how these industries have been able to eliminate the major portion of their tax burden.

These corporations have done nothing illegal in lowering their tax rates—they have simply taken advantage—quite effectively—of the multitude of tax subsidies which have been enacted into the tax laws over the years.

The investment tax credit, with a yearly cost of $3 billion, has failed to place an emphasis on new capital expansion. 57 percent of the investment credit went to those industrial corporations with over a quarter billion dollars in assets—approximately 260 corporations. Small corporations and businesses only see crumbs of the investment credit.

The tax advantages which these large corporations are receiving and which are concentrated in the largest corporations have a questionable effect on the Nation's employment. This study shows that the top 100 U.S. corporations are providing less jobs as their corporations expand. In 1969, the sales for the top 100 was $280.4 billion; in 1971 sales amounted to $315.2 billion—an increase of 12.5 percent in sales. But in 3 years employment in these top 100 corporate giants dropped by 5.2 percent or 500,000 workers. The last 100 companies on the Fortune list—that is, companies 401 through 500 increased sales by 16 percent but also increased employment by 1.4 percent.

Present tax laws and their interpretation by the administration seem to indicate a drastic phaseout of corporate contribution to the cost of government. If corporations are to reduce their contributions to the Government, how will the deficiency be made up?

Then it might be argued, "well, if the corporations don't pay taxes, their dividends do." But to what extent is this true? To what extent are American corporate profits a closed cycle? What percentage of corporate stock is owned by other corporations who pay little or no tax on dividend income? If three American citizens could earn $7,-353,000 in dividends in 1970 and pay no U.S. taxes, how many other billions of dollars in dividend income are tax free?

Records suggest that the dimension and capacity to create tax deductions is directly related to the size of dividends received. The extent of dividend tax avoidance cannot be estimated without some plan of dividend withholding.

Thank you.

(The prepared statement of Representative Vanik follows:)

Prepared Statement of Hon. Charles A. Vanik

Corporate Federal Tax Payments and Federal Subsidies to Corporations

Senator Proxmire, Members of the Committee, today's testimony is, in a sense, a follow-up to the presentation which I made before your Committee on March 21st on the subject of the Value-Added Tax and possible revenue raising alternatives. At that time, I indicated my opposition to VAT—a regressive National Sales Tax—and pointed out that an examination of several major corporate reports indicated that some corporations were making profits, paying dividends—yet paying no Federal corporate income tax. During my testimony, it was agreed to proceed with a formal, organized study of America's largest corporations and the level of Federal taxes which they paid.

A portion of that study is now completed. I believe that it provides valuable information on the questions of corporation tax policies and inequities and dis-

tortions created by some of the tax subsidies which have been enacted. These policies have a definite inter-enterprise effect as well between corporations and individual persons.

SCOPE AND METHOD OF SURVEY

My study examines 145 companies selected from the 1970 Fortune magazine lists of large corporations, and covers the years 1969, 1970, and 1971. These include: The top 100 industrial corporations; 20 airlines, railroad and trucking corporations; 10 telephone, electric power and gas transmission corporations; the 6 largest retailing corporations; and the 9 largest commercial banks.

The study is based entirely on information available to the general public, including 10-K reports, registration statements, and prospectuses filed with the Securities and Exchange Commission, as well as annual reports to shareholders and annual reports to the Interstate Commerce Commission.

The attached table shows the approximate taxable income, taxes paid and effective tax rates of the companies studied, where the information could be secured from public sources. It should be noted that the figures presented in the table represent approximations rather than precise figures. In a few isolated cases, the margin of error may be considerable. This is because the public sources generally did not present the data in a way in which they could be used directly to calculate the effective tax rates of the corporations. Adjustments were necessary in order to arrive at approximate figures.[1] Because of the complexity in reporting, it was not possible to obtain data for each corporation on the "top 100" list. The sample in the study is as follows:

Year:	*100 industrial corporations sample*
1969	80
1970	92
1971	48

The confusion, complexity and secrecy which shrouds corporate tax and financial reporting is nearly indescribable. I will comment on these problems later in my statement. *Let me say here that I believe the figures in the charts are as accurate as they could be made by my staff, aided by expert Certified Public Accountants.* If there are errors, the fault probably lies in the unnecessary complexity used by corporations in submitting data which was designed to serve the public—but which is almost completely obscured from public scrutiny.

FINDINGS OF STUDY OF FORTUNE MAGAZINE LIST OF TOP 100 U.S. INDUSTRIAL CORPORATIONS

Mr. Chairman, the study which I have completed, and which is attached to this statement, provides ample evidence that America's corporate giants have been able to utilize the tax subsidies included in the Internal Revenue Code to obtain an effective tax rate lower than the average tax rate paid by all American corporations. Some of these corporate giants have managed to escape

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[1] The SEC statements, for example, show Federal income taxes for financial reporting purposes that frequently differ from the amount actually paid. This, in turn, is due to differences in timing of income and expenses.

To illustrate, the SEC statements frequently report depreciation expenses on the basis of straight-line depreciation over the useful life of the asset. However, for tax purposes, class life depreciation (ADR) and accelerated depreciation methods are usually used where allowable. Similarly, some companies spread investment credits over the entire life of the asset for book purposes. Other examples of such differences in timing for book purposes and tax purposes concern installment sales which are reported on a full accrual basis for book purposes and on an installment basis for tax purposes. Similarly, for book purposes, warranty expenses are deducted on an estimated basis in the year the warranty is issued while for tax purposes, warranty costs are not deductible until actually incurred.

The effective tax rates presented in this study were arrived at after adjusting both the corporate income and the Federal income taxes shown in the public statements.

In general, the tax base (i.e., corporate income) used in this study was computed by taking the net income after tax shown on the company income statements and adding back the Federal income tax expense shown in the statements. In some cases, adjustments were made—the type of adjustments required to make sense of the SEC filings further described in detail in the appendix.

It is important to note, though, that in some cases, the tax expenses shown in the company's statements present one aggregate figure for combined Federal, State and local and/or foreign income taxes. Since, in these cases, it was not possible from the published data to exclude the state and local, or foreign income taxes, the entire tax expense was treated as Federal income tax expenses—except where the State and local or foreign income taxes were believed to be extremely significant, in which case the data for that company were deleted from the study.

all Federal tax payments—despite the fact that they are earning substantial profits and paying out dividends. In fact, 1971 was the best profit year for American corporations in the last 5 years.

The following table lists the number of industrial corporations in the top 100 of the *Fortune* list who made profits but which paid no Federal corporate taxes:

	1969	1970	1971
Number of corporations	7 out of 73	9 out of 86	5 out of 45.
Amount of taxable income on which no tax was paid	$862, 500, 000	$682, 000, 000	$382, 000, 000.

Those profitable corporations which paid no Federal income tax in 1971 were:

	Taxable income—but no tax paid
Continental Oil	$109, 030, 000
McDonnell Douglas	144, 613, 000
Gulf & Western Industries	51, 381, 000
Aluminum Co. of America	50, 199, 000
Signal Companies	26, 863, 000

Because the figures for 1971 include only 45 out of the 100 corporations, the total corporate income escaping tax for 1971 will obviously be much higher. Using proportions, it may approach $1.2 billion.

The next table lists the number of corporations in the Fortune 100 list which made profits but paid an effective Federal tax rate of only 1–10 percent:

	1969	1970	1971
Number of corporations	10 out of 78	13 out of 86	6 out of 45.
Amount of taxable income on which less than 10 percent U.S. corporate tax was paid.	$3, 377, 000, 000	$3, 171, 000, 000	$2, 327, 000, 000.

Therefore, the next table summarizes the two previous tables providing the total figure of those corporations which paid no Federal income tax or less than a 10% effective rate.

	1969	1970	1971
Number of corporations	17 out of 78	22 out of 86	11 out of 45.
Amount	$4, 239, 500, 000	$3, 853, 000, 000	$2, 709, 000, 000.

I am sure that every American citizen will be shocked and disappointed at the way in which many of these corporations have avoided the "nominal" or "statutory" Federal tax requirements. I hope that the revelation of the fact that many corporations are completely or substantially escaping support of the Federal government will cause all Americans to consider the need for tax reform—not just individual tax reform, but corporate tax reforms as well.

Great public concern and indignation has been focused on those 107 Americans who received more than $200,000 in income last year yet paid no Federal income taxes. But put the facts in perspective: those 107 Americans received a total of $26,000,000 tax free. In 1970 nine corporations out of the top 86 had a pre-tax income of $682,000,000—yet paid no Federal taxes!

But this study has more to teach us than the fact that we need tax reform.

This study documents, in many ways, how the Federal tax system is encouraging the growth of monopolies, conglomerates, and supranational corporations. It reveals how many of the tax subsidies provided by the Congress have outlived their usefulness and are now creating severe problems in inequity and injustice between corporations—both within the same industries and between different industries.

THE FEDERAL TAX CODE FAVORS THE GIANT CORPORATION

The average effective tax rate of all American corporations in 1969 was 37%. But the average tax rate for the top 100 industrial corporations was 26.9%. This means that the smaller corporations appear to be paying a rate above the average! It is my estimate that the smaller corporations—those under the top 100—pay, on the average, a rate of 44%. Obviously the giant corporations enjoy greater cash and more subsidiaries—thus driving the smaller firms which pay higher rates of taxation out of business.

The trend of "low" effective tax rates for the "100 giants" appears to be accelerating, as the following table shows:

	Effective tax rate (percent)	Size of sample (profitable firms only)
1969	26.9	78
1970	25.8	86
1971	24.4	45

While the average effective tax rate for these "giants" is in the upper 20 percent level, there are a number of industries within this group with much, much lower tax rates.

The steel industry, particularly U.S. Steel, has paid a low effective tax rate over the past three years.

Some oil giants have—in some years—paid high effective tax rates. Standard Oil of Ohio, for example, paid a 41.1% rate in 1969—and, apparently, no tax in 1970. Out of the 17 oil companies studied 10 paid less than 10% in 1969 and 7 paid less than 10% in 1970.

The timber industry giants pay effective tax rates of between 10–20 percent on large pre-tax incomes.

Each of these industries is a horror story of tax avoidance. Later in my statement, I have provided sections briefly describing how these industries have been able to eliminate the major portion of their tax burden.

HOW DO CORPORATIONS REDUCE THEIR TAX BURDENS?

These corporations have done nothing illegal in lowering their tax rates—they have simply taken advantage—quite effectively—of the multitude of tax subsidies which have been enacted into the tax laws over the years.

Your Committee has been examining the efficiency and justification for a number of these subsidies. It is vital that we in the Congress—and the entire American public—make a careful examination of these subsidies which place the Federal tax burden on the individual taxpayer, provide enormous benefits to a very few, and have resulted in terrible inefficiencies in the use of our resources.

As I will point out in later sessions of this testimony, many of these subsidies have failed in their purpose.

1. The Investment Tax Credit, with a yearly cost of $3 billion, has failed to place an emphasis on new capital expansion. It is one of the most inefficient ways of reducing unemployment. It has done little to end the recession.

The tax advantages which these large corporations are receiving and which are concentrated in the largest corporations have a questionable effect on the Nation's employment. This study shows that the top 100 U.S. corporations are providing less jobs as their corporations expand. *In 1969, the sales for the top 100 was $280.4 billion; in 1971 sales amounted to $315.2 billion—an increase of 12.5% in sales. But in these three years employment in these top 100 corporate giants dropped by 5.2% or 500,000 workers.* The last 100 companies on the Fortune list—that is, companies 401 through 500 increased sales by 16% but also increased employment by 1.4%.

2. The subsidies to the oil industry have failed to increase petroleum reserves, yet its cost is measured in the billions.

3. The tax subsidies for the timber industry have failed to insure the proper logging conservation practices for which it was designed.

4. The Foreign Tax Credit—and other foreign investment subsidies—have exported jobs, domestic capital needed for increased American productivity, and removed billions from the U.S. Treasury.

The failure of these various tax subsidies—and others—are discussed in greater detail in the detailed portions of my testimony.

Let me simply say, it is time that these tax subsidies must be reviewed and modified if the smaller corporations are to survive absorpton by the giants with their tax advantages.

Aided and abetted by our tax laws—the free enterprise system in America has become one large chicken factory where little chicks are grown to maturity and made marketable to satisfy the unending appetite of conglomerate corporate America.

CONFUSION IN CORPORATE REPORTING

Corporations, through complex reporting procedures, have made it impossible—in all too many cases—to accurately estimate, from public sources, the actual Federal income tax paid for any particular year. *The annual reports are a "mirage of ambiguous statements"* that lead the stockholders to believe that business is better and profits are improving. The tax statements of these same companies to Internal Revenue often illustrate a completely different picture that reduces their profit figure, which in effect, reduces their total tax figure. Like the medieval European peasants, for their stockholder they wear their wedding clothes; for the tax man, they wear rags.

TAX RATE VARIATIONS AMONG CORPORATIONS

The attached tables show the approximate effective rate of Federal income tax paid by the companies covered by the study after the adjustments described above. It indicates considerable variation in effective tax rates not only as between companies in different industries, but for different companies in the same industry and for the same company in different years.

Retail companies generally are among those paying the highest effective Federal income tax rates of the companies covered by the study. The approximate effective rates for four retail companies for example (A&P, Kroger, J. C. Penney, and Federated Department Stores), on a combined basis for 1969, 1970, and 1971 were 43.8. 42.4 and 38.0 percent respectively.

Some industrial firms pay a relatively high effective tax. duPont, for example, paid an effective Federal income tax of 42.2 percent in 1971 and 43 percent in 1970. Other industrial firms, however, pay a considerably lower effective rate. The effective income tax rate for Union Carbide, for example, was 18.6 percent in 1971 and 20.6 percent in 1970. Simiarly, Allied Chemical Corporation paid an effective rate of 9.5 percent in 1970 and 4.4 percent in 1969.

The eight largest railroads, excluding Penn Central, all reported net income to their shareholders in 1970. In that year, these eight companies had a combined net income before Federal income tax of about $529 million and paid approximately $26 million in Federal income tax for an effective rate of 4.9 percent.

There was also substantial variation in the effective rates paid by different commercial banks. Chemical New York Corporation, for example, paid an effective income tax rate of 31.1 percent in 1971, 33.1 percent in 1970, and 39.4 percent in 1969. In contrast, the First National City Corporation had effective income tax rates of 28.6 percent in 1971, 19.6 percent in 1970, and 16.9 percent in 1969.

TAX CODE PROVIDES INCENTIVES FOR CONGLOMERATE ACQUISITION

For the past twenty years our corporate powers have been driving the small manufacturers, businessmen, and shop owners out of business. We seem to have assumed that small business is obsolete and have equated bigness with efficiency and productivity. We have proceeded on a course of centralization—but we have moved beyond economics of scale and into economics of monopoly.

This trend has been no accident—the tax subsidies of the Internal Revenue Code have made a calculated attack on small businesses and provided incentives for large corporations to buy up small successful companies for tax and cash flow purposes. Often, even unsuccessful operations can be purchased and used to reduce the total tax liability of the larger purchasing company.

Under certain definitions in section 368 of the tax code, large corporations purchase smaller operations permitting the seller to avoid any payments on capital

gains from the sale. For example, as a small or medium sized business owner I might be tempted by an offer from a large corporation that would be hard to turn down. Under section 368 of the code, we could make an exchange of stock so that the large corporation would take complete control of my company. This is a "tax free exchange."

These provisions provide an incentive to sell and have paved the way for huge conglomerates. As small operations find it hard to compete, the small owners find these offers hard to turn down. The future profit streams of these small companies are sold tax free, thus undermining the future of the small business in this country.

Many of the giant corporations in the Fortune "100" list, as well as many of the leading banks listed in the study I am submitting today, are conglomerates or monopolistic companies. In many, many cases, the purchase of smaller corporations by these industry giants has given them the opportunity to invest in tax shelters and, in general, to maximize their use of tax subsidies. For example, a company which is in a field where there are few tax subsidies can purchase a "tax subsidized industry" and use that subsidiary to help lower or eliminate its effective Federal tax rate. This is particularly true of an increasing number of the Nation's largest banks and insurance companies. It is necessary for Congress to determine how some banks can enjoy a 16% tax rate. This indicates tremendous investments in tax-sheltered activities.

This study of the effective tax rates of the Nation's largest 100 corporations should provide valuable information as to whether the advantages of big business are the proximate result of tax policies unrelated to maximum economic efficiency for the public good. Again, as I pointed out at the beginning of my statement, the effective tax rates of these industry giants was 26.9% in 1969, but the overall American corporate effective tax rate was 37% in 1969. This means that the smaller companies are paying an average rate of about 44%. Conglomerate and "trust" growth helps the rich get richer, the big get bigger—and the small to lose out. The tax subsidy system of the Internal Revenue Code is encouraging this growth; it is destroying the old ideal of competitive American free enterprise.

The small business does not have the ability to fully utilize the tax benefits available to the conglomerates, ITT in 1969 had a net income before federal income tax of about $360,000,000 and an effective tax rate of over 14%. In 1971 ITT's net income before federal taxes was approximately $410,000.000 and an effective tax rate of almost 5%. As ITT grows, its tax rate shrinks. The 10–K for ITT indicates that the Hartford Co. and ITT filed a consolidated tax return on which no tax was paid—although some tax was paid by other subsidiaries.

In 1970 ITT filed a consolidated return with its domestic subsidaries and reported a before tax income to its shareholders of almost $430,000,000 and according to their 10–K report to the SEC, no corporate tax was due on the consolidated return, though again, some taxes were paid by subsidiaries.

ITT also sold stock during that tax year to an overseas bank and the foreign buyer almost immediately resold the shares to a fund in this country. This fund already held some of ITT's pension money. This sale to a foreign bank, rather than directly to the fund, appears to have been motivated by the desire to increase its foreign tax credit benefits.

Mr. Chairman, the smaller businessman has almost no "tax subsidies available to lower his tax rate to the level of the giant manufacturing conglomerates. These large conglomerates should be reviewed by the Joint Committee—not just for adequate disclosure but to evaluate how these giant corporations manipulate the tax code to constantly reduce their tax burden, and thus increase their cash reserves used to acquire more and more assets—and more and more tax shelters.

The tax code should be closely examined to eliminate some of these "incentives for acquisition" which primarily serve to dismember the corporate tax structure for large conglomerates.

Let there be no doubt that the growth of new conglomerates is the move of the future, unless action is taken to reduce these incentives for acquisition and the endless acquisition of foreign and domestic tax shelters which only the largest corporations can afford "to diversify" into.

In the period 1961 to 1968 eight companies dominated conglomerate growth, each of which made acquistions during these years totaling more than one-half billion dollars each.

Acquired assets as percent of total assets from 1961 to 1968

Company:	*Percent*
ITT	59
Gulf and Western	83
Ling-Temco-Vought	72
Tenneco	31
White Consolidated	86
Teledyne	90
Occidental Petroleum	43
Litton	43

Many accounting devices enable these merger-active companies to report substantial increases in earnings per share without improving operating efficiency—or "real" national growth. The most notorious of these devices is the "pooling of interests" method of accounting for combinations. Under the pooling of interest, the book value of both businesses are simply added together. In this circumstance, the book values prevailing at the time of acquisition need have no relation to the actual market value of the transaction. Through acquisition, an acquiring company can do what it cannot do through internal growth—that is, list the value of assets at less than real costs, and later report this difference as growth income.

From the viewpoint of a conglomerate's management, it matters little whether the gain in earnings is illusory or real as long as it "looks good" to the stockholders.

THE ATROPHY OF SMALL BUSINESS

Small business in America is in crisis. Every year the scraps from the table of big business for which small businesses must fight get smaller.

The share of national profits for manufacturing corporations with assets under one million dollars declined 44.8 per cent between 1969 and 1970. Between 1970 and 1971, there was an additional decline of 3.9 per cent. This decline in profits for corporations under one million dollars is especially significant when compared with the fact that profits for manufacturing corporations with assets over one billion dollars declined only 7.2 per cent between 1969 and 1970 and rose 14.3 per cent between 1970 and 1971.

The share of total corporate profits of firms with assets over one billion dollars has nearly doubled since 1959—from 28.4 per cent of all profits in that year to 54.6 per cent in 1971. In 1971, almost 55 per cent of all corporate profits in America was achieved by the billion dollar corporations, only 260 corporations in number. What is left for the 1,700,000 other corporations of America?

SHARE OF TOTAL PROFITS, FIRMS WITH ASSETS OVER $1,000,000,000

	Profits (in billions)	Total of all profits	Share, percent
1959	5.236	16.328	28.4
1964	9.489	23.211	40.0
1969	15.978	33.248	48.0
1971	16.9	31.0	54.6

MANUFACTURING CORPORATIONS, SALES

[In percent]

	Assets under $10,000,000	Assets over $100,000,000
1954	3.14	46.4
1959	2.98	50.25
1964	2.75	55.07
1969	2.26	63.74
1970	2.10	65.64
1971	1.98	67.85

These figures are signposts of the slow death of competitive free enterprise in this country.

It is shocking indeed to realize that over 188,000 industrial firms with assets under $10 million today account for less than 2 per cent of all industrial sales. In 1970, the 500 largest industrial corporations accounted for 65.4 per cent of all industrial sales, 75.8 per cent of all industrial profits, and 44.3 per cent of all industrial employment.

There are more than 11 million firms that are considered to be small businesses—97.7 per cent of all U.S. firms have fewer than 100 employees. These small businesses employ 24 million workers—and they are finding survival difficult.

The tax code has provided the "launch-pad" for the conglomerate growth of the 1960's. For example, the Library of Congress has just released a report on the corporations which used the Investment Tax Credit in 1965—the last year for which specific figures are available. Fifty-seven per cent of the credit went to those *industrial* companies with assets of more than a quarter billion dollars—approximately 260 industrial firms.

There is no doubt that our tax policies have favored the large at the expense of the small. It is my recommendation that the tax code be thoroughly re-examined so as to provide a growth pattern for all business sectors of our economy—not just for the corporate giant who has invested in tax subsidy shelters.

My staff studies indicate that our tax laws mischievously operate to suppress small business—to deny an equality of opportunity for small free enterprise to compete with the "big brothers" who can utilize the tax laws to reduce their effective tax rates and to generate extra muscle to complete with and devour small business.

It is time for Congress to examine what effect tax policy is having on the aggressive destruction of small business, for which a place must be shared.

In 1971, almost 55 per cent of all corporate profits in America were achieved by the billion dollar sales corporations, only 260 corporations in number. What is left for the 1,700,000 other corporations of America?

Present tax laws and their interpretation by the Administration seem to indicate a drastic phase out of corporate contribution to the cost of government. If corporations are to reduce their contribution to the government, how will the deficiency be made up?

While some argue against corporate taxation on the basis that dividends pay taxes, to what extent is this true? To what extent are American corporate profits a closed cycle? What percentage of corporate stock is owned by other corporations who pay little or no tax on dividend income? If three American citizens could earn $7,353,000 in dividends in 1970 and pay no U.S. taxes, how many other billions of dollars in dividend income are tax free?

Records suggest that the dimension and capacity to create tax deductions is directly related to the size of dividends received. The extent of dividend tax avoidance cannot be estimated without some plan of dividend withholding.

It is my contention that a massive portion of dividend income completely escapes the tax collector. Under present laws, dividend taxes cannot substitute for a fair and adequate system of corporate taxation.

We are in a vicious circle. We cannot change or remake the tax laws without facts—and we cannot obtain essential facts because of laws that shroud and conceal the truth to which every citizen is entitled. There can be no decent measure of tax justice when facts are buried and needlessly protected by archaic laws. What the public does not know and cannot know does indeed hurt every citizen.

FEDERAL TAX RATE IN STEEL INDUSTRY

In examining the top five steel companies in America, it appears that Armco, Republic, and National Steel have been paying Federal corporate tax, although the effective tax rate has consistently been below the average rate paid by the combined top 100 industrial corporations.

U.S. Steel, however, received a credit or a reduction in its tax liability of $66,000,000 in 1970. I am aware that the GM strike in 1970 held down profits—but even in 1970, U.S. Steel had a net income of $109,000,000 before Federal income taxes.

In 1969, U.S. Steel paid an effective rate of 2.1% on a quarter billion dollars in taxable income. It appears that U.S. Steel may have paid a 7.6% tax rate on $104,516,000 in 1971. Thus, over the three years, the company has received more in tax credits and/or reductions in their tax liability than it has paid in

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U.S. taxes. The question which remains to be answered is whether, in fact, U.S. Steel will have paid any taxes after all subsequent tax credits are requested and applied to 1971 revenue.

Bethlehem Steel in 1969 had a net income before taxes of $169,000,000—that same year Bethlehem received $52,000,000 from the Treasury in the form of a credit or a reduction of their income tax liability.

It is probable that this trend of "low tax on steel" will continue for at least three or four years, as the full effect of the 1971 Revenue Act unfolds through the give-away provisions of ADR and the investment credit.

THE OIL INDUSTRY AND TAX SUBSIDIES

In examining the effective tax rate of the various industries in this study, it comes as no surprise that the oil industry has, on the average, a low effective U.S. corporate tax rate. From available data, it appears that the industry leaders paid an average effective rate of 5.8 percent in 1969 on $4.7 billion in pre-tax income. In 1970, they paid an average of 10.1 percent on $4.6 billion in net income. On the 8 companies for which data was available for 1971, an average effective rate of 6.1 percent was paid on some $2.5 billion in income. Total tax credits or "refunds" to the industry in this period was $31.4 million.

This study shows that the tax subsidy system for the oil industry is the most extensive one in the entire Internal Revenue Code.

The three major tax subsidies to the oil industry are:

1. the percentage depletion allowance;
2. special provisions which permit the current write-off of "intangible" drilling and development costs; and
3. the Foreign Tax Credit.

The Foreign Tax Credit is probably the greatest boon for the major oil companies. Most of these companies are international in character and use their taxes paid to foreign countries to reduce any tax liabilities which they may have to the U.S. government. Incidentally, many of these taxes used to be royalties which could only be treated as a business deduction; but over the years the companies and the foreign host nationas have shifted these royalties into the category of taxes. to the great profit benefit of the American Corporations. The use of the Foreign Tax Credit is concentrated in the largest of the oil companies. This can be seen by a pro-oil subsidy letter which I recently received from the American Petroleum Institute. The major petroleum companies studied by the Institute account for 95 percent of the direct foreign taxes paid by the total U.S. petroleum industry— and thus obtained approximately 95 percent of the benefit of the Foreign tax Credit. America's 18 leading oil companies admit to paying more to foreign governments than to their own.

I have argued in another section of this report that the Foreign Tax Credit should be abolished and replaced with a deduction so that all U.S. corporations are treated equitably—regardless of where the profit is earned. The oil industry provides a classic example of the need for modifying the Foreign Tax Credit subsidy.

The depletion allowance and the intangible drilling provisions are providing multi-billion dollar tax subsidies to this industry, designed to encourage exploration and the maintenance of national defense petroleum reserves.

It is one of the commendable purposes of these hearings to examine and re-examine the various tax subsidies which have "pot bellied" the Tax Code. Is the depletion allowance a desirable tax subsidy? Does it accomplish its goal? Does it have a favorable benefit-cost ratio?

This subsidy does not meet these criteria for a justifiable subsidy. It has been pointed out that the percentage depletion allowance costs the public $1.5 billion and results in an annual expenditure of only some $150,000,000 for new exploration and new reserve discovery. In other words, this subsidy has an efficiency rate of about 10 percent. During the Congress' consideration of the 1969 Reform Act, a thorough study of the tax laws and their effect on domestic petroleum reserves was provided by the Treasury. This study noted:

> Percentage depletion is a relatively inefficient method of encouraging exploration and the resultant discovery of new domestic reserves of liquid petroleum. This is in part due to the low sensitivity of desired reserve levels to the price subsidy represented by percentage depletion, *and in part to the inefficiency of the allowance for this purpose since over 40 percent of it is paid for foreign production* and nonoperating interests in domestic production. (Emphasis added)

The study concluded that an elimination of the depletion allowance and the intangible drilling provision would make a "statistically significant" reduction in our reserve supplies—though the elimination of just one of these provisions, which would save hundreds of millions of dollars, would have "no significant effect" on the reserve level.

It is time that we throw out these subsidies and develop rational programs which will achieve our national petroleum goals. For example, the Oil Import Quota Law encourages the consumption and depletion of our oil fields and is in opposition to the national defense reserve argument. It should be replaced with a revenue raising tariff or be completely removed, saving the consumer about $7 billion a year. Consideration should be given to creating a national petroleum reserve—a stockpile of oil, ready for use in an emergency. Once this reserve was established, the national security issue would be removed and we could allow the private market factors of supply and demand work. Other alternatives to the present inefficient subsidies have been suggested. I understand that you, Mr. Chairman, have suggested a modified use of some of the present subsidies so that their impact is efficiently concentrated on exploration. If controls can be developed to prevent "frivolous" exploration for tax purposes. such a modification in present tax law might result in major savings—an increased petroleum discoveries.

THE TIMBER INDUSTRY SUBSIDY

In examining this list of 100 corporations, there is another industry which stands out for its low effective tax rate—the timber industry. Because of the nature of giant corporations and conglomerates, it is hard to say who exactly composes the timber industry. The following firms, however, undoubtedly qualify as leaders in the field:

Weyerhaeuser
Georgia Pacific

The total net income before tax of these two companies in 1969 was $306,400,000. Their average effective tax rate was 18.5%. In 1970 they had a pre-tax net income of $277,700,000 and an average effective tax rate of 14%. Treasury studies once again indicate that the vast majority of the timber tax subsidy goes to just a few. In 1965, corporations in the lumber and paper industry reported $443,400,000 of long-term capital gains. This represented a tax savings for the corporation of between $100,000,000 and $140,000,000. In 1965, there were 13,251 corporate returns filed in the lumber and paper industries. Of these returns, the 16 corporations with assets over $250,000,000 reported 64.8 percent of the long-term capital gains. The 63 corporations with assets over $50,000,000 reported 80.4 percent of the long-term capital gains. Recent figures indicate that the largest companies are utilizing an ever increasing portion of the industry's capital gains subsidy. By the nature of capital gains, the small logger receives almost no benefit from this subsidy.

When this timber capital gains tax subsidy was originally passed in 1943, President Roosevelt vetoed it, saying, it was a tax bill "for the greedy, not the needy." His words are still true today.

In addition, the bill was originally passed to help encourage forest conservation. I really wonder whether it has achieved this purpose. At the present time, there are some 52 million acres of private forest land which are in need of reforestation. The Federal government is making direct expenditures of over half a billion a year in forest service activities, and the Congress recently passed a new bill providing $65–75 million for the reforestation of the National Forests—and much of this money will be spent to repair the damage caused to the public land by the timber industry.

Your Committee has again provided a valuable public service by including in its compendium of study papers on Federal Subsidy Programs, the article by Emil M. Sunley, Jr., entitled, "The Federal Tax Subsidy of the Timber Industry." As Mr. Sunley states:

> In view of the significant subsidies being extended to the timber industry through direct government appropriations at both the Federal and State level, the difficult administrative problems associated with the tax subsidy, and the lack of evidence that the tax subsidy is effective, one concludes that this tax subsidy should be eliminated or significantly reduced.

It would be particularly important to consider alternative forms of assistance which would ensure better conservation of our nation's timber resources.

FOREIGN TAX CREDIT PROVIDES CORPORATE TAX AVOIDANCE

The Foreign Tax Credit is doing its part to dismantle corporate tax payments to the U.S. Treasury. Many of the large corporations included in this study have utilized the Foreign Tax Credit to reduce their Federal tax liability to zero—or to rates below that paid by the average individual wage-earner. Some corporations, as apparently is the case with U.S. Steel, pay more to foreign governments than they do to their own.

Our tax laws are encouraging the exportation of capital, productivity potential, jobs, and possible export markets, as well as needed tax revenue—all for the benefit of a very few corporations. Use of this foreign investment tax credit is heavily concentrated in the largest U.S. corporations. Over 80 percent of taxable foreign source income in 1966 accrued to a very limited number of U.S. corporations with assets in excess of $250,000,000.

In 1970 the total income before taxes on U.S. direct investment abroad amounted to $17.5 billion, or 20% of all corporate profits. The magnitude of these direct investments are currently valued at $80 billion and produce at least $150 billion of output annually.

These profits on foreign investments are taxed in foreign countries. While foreign governments receive the revenue from U.S. overseas investments, U.S. corporations credit these tax payments against their U.S. taxes. In 1970, $4 billion in foreign tax credits were claimed by U.S. corporations on their tax statements.

Most of the earnings of U.S. corporate subsidiaries abroad are reinvested in fixed assets—this amounts to a permanent exemption from U.S. tax. These foreign subsidiaries paid $.9 billion less than they would have paid under U.S. tax rates.

It is argued that the Foreign Tax Credit is necessary to prevent double taxation of a company's business activities. It is argued that there should be equality in total tax burdens including foreign as well as U.S. taxes. But I believe that we should seek to establish equal treatment in U.S. taxes, by treating foreign taxes as a cost of doing business for which one may obtain a deduction—not a credit.

This whole question is thoroughly discussed in Professor Peggy Musgrave's study, "Tax Preference to Foreign Investment," which was included in your Committee's compendium of papers published on June 11, 1972. Professor Musgrave has provided an excellent study. It is one which must be considered by all the Committees which will be dealing with tax reform legislation in the coming year.

These deferrals and Foreign Tax Credit provisions should be eliminated—and foreign taxes should be made deductible. U.S. taxes should be applied when foreign income has been earned—adding $3.3 billion to the U.S. Treasury.

According to a recent Forbes magazine article, certain individual shipping owners, such as billionaire Daniel Ludwig, the shipping magnate, have amassed incredible amounts of wealth having paid little if any taxes. Mr. Ludwig's tankers are tax-free—avoiding the tax man through the "flags of convenience," a tax shelter permitted in the U.S. tax code.

Mr. Chairman, all U.S. corporations should pay the same effective Federal tax rate applied to all profits—whatever their source of business—whatever their source of profits.

TAX CODE PROVIDES TAX AVOIDANCE FOR CONSOLIDATED EDISON AND AMERICAN ELECTRIC POWER

Within the corporate structures of the ten utilities included in this study, there are two corporations that have reduced their effective tax rate to about 3% and 4%—Consolidated Edison and American Electric Power.

In 1969 Consolidated Edison had a net income before Federal income taxes of $141,000,000 and had an effective tax rate of 5%. In 1970 Consolidated's net income was $110,000,000 and it paid no tax. In 1971, it almost doubled its net income to $202,000,000 but its effective tax rate was only 3.3%. Most individuals pay a higher percentage personal income tax rate than this corporation provides to the U.S. Treasury.

Closer investigations illustrate one of the major tax cutting procedures which Con Edison used.

Notes to Consolidated Edison's financial statement indicate net operating losses for tax purposes for both 1970 and 1971—while the 1971 net income reported to shareholders was the highest in any of the previous ten years of the company's

history. Dividends paid were $102,065,000—1969, $108,021,000—1970, and $119,-406,000—1971. None of the dividends on the common stock for these three years, which amounted to $81,183,234 and $73,436,126 for 1971 and 1970, were taxable as dividend income. No taxes were paid on this dividend income because of the accounting procedures which manipulate the tax laws.

Also, Consolidated Edison in 1969 retroactively adopted guideline depreciation. As a result, for the years 1962 through 1968, the company received $48,500,000 in refunds plus interest from the Federal Treasury of $17,500,000. It is obvious that this $48,500,000 "excess" tax paid, and later refunded, had been passed on to their customers in a higher rate structure in those years. When refunded, the money and the interest were recorded as nonoperating or extraordinary items.

Why should any taxpayer, least of all a utility, obtain interest on a refund or federal taxes brought about by a calculated election of a retroactive application of any particular tax provision.

Therefore, I have introduced legislation which would outlaw the free choice of utilizing any provision of the tax code retroactively for the purpose of reducing current and future taxes for any corporation. The changing of the "rules" in midstream must be prohibited when it has a negative impact on the consumer and the Treasury.

The second example, American Electric Power, has turned the theory of progressive taxation upside down. In 1969 American Electric had a net income before taxes of $133,000,000 and had an effective tax rate of 23%. In 1970, this same company's net income declined by $2 million while their taxes were reduced by 40%. In 1971 American Electric's pre-tax net income increased by about $13,-000,000—the highest pretax income they had in three years. Yet their effective tax rate dropped from 13.2% to an amazing 4.5%. As this company's income increases, its tax has plummeted.

DECEPTION IN CORPORATE FINANCIAL REPORTING

Corporations, through complex reporting procedures, have made it impossible—in all too many cases—to accurately estimate, from public sources, the actual Federal income tax paid for any particular year. The annual reports are a "mirage of ambiguous statements" that lead stockholders to believe that business is better and profits are improving. The tax statements of these same companies to Internal Revenue often illustrate a completely different picture that reduces their profit figure, which in effect, reduces their total tax figure. Like the medieval European peasants, for their stockholders they wear their wedding clothes; for the tax man, they wear rags.

By far the major problem in understanding corporate tax reporting is the combination of Federal tax expense with state, local, and foreign tax expense when reporting to the SEC.

U.S. Steel, for example, combined their U.S. and foreign income taxes so that even after careful study, an informed citizen cannot tell who was paid what without calculations and careful work with footnotes. General Motors may have combined their U.S. and foreign taxes so that you cannot decipher what was paid or owed to the U.S.—and what was paid to other countries. IBM, the fifth largest corporation in this land, combined their foreign and Federal taxes in all public records, including their 10–K forms. The following companies did the same:

RCA
National Cash Register
Colgate Palmolive

These companies have disregarded SEC rules on disclosure. For commercial and industrial companies, SEC rule 5–04,15 provision for income and excess profits taxes (regulations S–X, page 12) requires that: (1) Federal income taxes (normal and surtax); (2) Federal excess profits tax; and (3) other income taxes (state, local, and foreign) be stated separately. Yet these companies—and many others—have combined all income taxes into one expense figure.

In addition, even where the Federal income tax expense figure is separately stated, the various deferred income taxes may be combined in one of the deferred tax accounts affecting the estimate of current taxes. Since, in these cases, it was not possible from the published data to exclude the state and local or foreign income taxes, the entire tax expense was treated as Federal income tax expense. This tends to overstate to some degree the Federal taxes paid. Where the state, local, or foreign income taxes were believed to be extremely significant, the data for that company was deleted from this study.

Over the past several months, I have made a series of protests to the SEC concerning the failure of the Commission to enforce its existing regulations, and I have urged that they develop clearer reporting requirements. On July 7, 1972, I received a letter from Chairman William Casey of the Commission, who admitted that the various "accepted" accounting rules do vary and do create a good deal of confusion. The Chairman also indicated that new Federal tax requirement rules had just been issued on June 23rd. I would like to enter in the hearing record at this point portions of the SEC letter as well as the language of the new reporting requirement:

> You also comment in your letter on the inclusion of excise taxes in the amounts shown as "taxes paid" in corporate reports. This is an area where differences in accounting treatment are currently acceptable. Some corporations report their sales net of excise taxes collected and paid to the government while others show the sales gross and report the taxes as expenses. There is considerable disagreemtnt among professional accountants as to which treatment is proper. The Commission has taken no position on this issue.
>
> Both the Commission's accounting rules and the opinions of the Accounting Principles Board require the disclosure of income tax expense. If income taxes and excise taxes are combined on the face of the income statement (as in the case with Standard Oil Company of New Jersey), there must be footnote disclosure of the components of the total figure (as there is in this case). The rules and opinions also require that income tax expense be divided between that currently payable and that deferred due to differences between tax return and book figures. Thus cash payments to the Federal government can be determined.
>
> The area of tax expense in accounting is generally one which is complex and difficult to communicate. We feel that our enclosed new rules (Rule 3-16(o) which is included in the amendment of Regulation S-X adopted on June 23) represent an improvement in required disclosure. We hope to continue this improvement and we appreciate your interest in the subject.
>
> *   *   *   *   *   *   *
>
> Rule 3-16 (o) *Income tax expense.*—Disclosure shall be made, in the income statement or a note thereto, of the components of income tax expense, including: (1) *taxes currently* payable; (2) the net tax effects, as applicable, of: (a) timing differences, and (b) operating losses; and (3) the net deferred investment tax credits. *Amounts applicable to Federal income taxes and to other income taxes shall be stated separately for each component, unless the amounts applicable to other income taxes do not exceed 5 per cent of the total for the component and a statement to that effect is made.* (Emphasis added.)

I would like to state, Mr. Chairman, that I object to the 5 per cent leeway given to corporations in reporting their Federal tax payment. This leeway will probably be used by corporations to improve their "Federal tax payment image" to the American public. This leeway should not be granted. There should be a strict requirement that the exact amount of corporate tax paid to the Federal government be clearly stated—not hidden in footnotes and obtained through mathematical calculations.

When an individual making $10,000 files his income tax—he has no choices among "generally accepted accounting principles" so as to conceal his income and reduce his tax. These "principles" are only generally accepted and used by the wealthy corporations of this Nation. They are "generally accepted" because no one understands them!

It is obvious, Mr. Chairman, that your Committee, and the entire Congress will never be able to legislate rationally in the area of corporate taxation until clear and accurate figures are available on the tax burden which the American corporation actually bears. The present accounting processes make a mockery of the public's right to know.

We are in a vicious circle. We cannot change or remake the tax laws without facts—and we cannot obtain essential facts because of laws that are not enforced or that shroud and conceal the truth to which every citizen is entitled.

Appendix

PROBLEMS AND PROCEDURES INVOLVED IN SECURING APPROXIMATE EFFECTIVE TAX RATES FROM PUBLIC INFORMATION SOURCES

The data contained in the tables were obtained from annual 10-K reports, registration statements or prospectuses filed with the Security and Exchange Commission (SEC), or from annual reports to shareholders, or in some cases from annual reports to the Interstate Commerce Commission (ICC).

Factors which make it difficult to accurately estimate from these sources the actual Federal income tax paid for a particular year involve:

(1) Combining Federal tax expenses with State, local and foreign tax expenses when reporting to SEC. This problem is discussed in the text of my statement and I will not repeat the problems caused by this abuse, although they are, by far, the most serious ones in attempting to determine the amount of Federal tax payment.

(2) Consolidating for financial reporting to shareholders companies that could not be included on a consolidated tax return;

(3) Reporting, to shareholders, the results of a subsidiary's operation by using the "equity method" when that subsidiary is included in the consolidated tax return:

(4) "Overstating" the Federal income tax accrual (liability and expense) in order to provide a reserve for anticipated tax deficiencies which may follow an audit by the IRS;

(5) The existence of a complex accounting procedure—"comprehensive tax allocation" sometimes referred to as interperiod tax allocation: and

(6) Netting tax effects against extraordinary gains and/or losses (intraperiod tax allocation).

Consolidations for financial reporting and taxes

Companies frequently consolidate for financial reporting foreign subsidiaries and subsidiaries that are 51 percent or more owned—generally they must be domestic subsidiaries and 80 percent or more owned before they can be included in a consolidated Federal income tax return.

In financial reports to shareholders, the *full* Federal income tax expense (as well as all other revenue and expense accounts after elimination of intercompany transactions) of all consolidated subsidiaries (even the 50 percent owned companies) is reported as though it were a tax (or refund) entirely attributable to the majority interest of the group. However, the minority interest in a particular subsidiary's net income (perhaps as much as 49 percent) is removed at the bottom of the income statement. Thus, the consolidated financial reports often show the full tax expense of even 51 percent owned subsidiaries and/or foreign subsidiaries while eliminating the income attributable to the minority interest.

To adjust for this, income attributable to the minority interest was added back to net income as an adjustment in reaching the tax base.

Method of accounting for an investment in a subsidiary

If the "equity method" is used in financial reporting to shareholders to account for an investment in a subsidiary not consolidated for financial reporting when that subsidiary is included in a consolidated tax return, the Federal income tax expense actually paid may exceed (or be less than) that reported on the consolidated financial statements. The "equity method" produces the same net income to shareholders as does consolidation (it is sometimes called a one-line consolidation). The proportionate part of the after-tax earnings of the subsidiary are shown on one line in the income statement; whereas in a consolidation, all income and expense accounts of the subsidiary (including taxes) are combined with those of the parent and other consolidated subsidiaries and the net after-tax earnings of a subsidiary attributable to a minority interest are later deducted. Thus, consolidation for financial reporting shows all Federal income tax expense recorded by all the consolidated subsidiaries while the equity method does not reflect any of the Federal income tax (or refund) attributable to subsidiaries accounted for via the equity method.

Because the Federal income tax attributable to the equity method net income was not disclosed, this income was removed from net income as an adjustment in reaching the tax base.

"Overstating" the provision for Federal income taxes

Many, and perhaps most, corporations "overstate" the accrued Federal income tax liability and thus the expense account in order to provide a reserve for anticipated future taxes due to IRS audits of tax returns for open years. This is done because corporations tend to resolve doubtful items in their own favor while realizing that many of these items will result in tax deficiencies upon audit by the IRS. Because the amount of this "overstatement" of the Federal income tax accrual account cannot be determined from the 10-K or annual report to shareholders, no attempt was made in the study to adjust for this effect in arriving at the estimated current Federal income tax liability.

Interperiod tax allocation

Another major problem in estimating Federal income tax liabilities involves the use of the accounting technique—"comprehensive tax allocation." The Accounting Principles Board (APB) in Opinion No. 11, stated that for most timing differences (income or expenses reported for tax purposes and for financial reporting to shareholders in different years, e.g., use of class life depreciation for tax purposes and engineering life for book purposes), the tax expense reported to shareholders must be based on book income. Thus, tax expense is usually larger than the tax paid which results in a "deferred Federal income tax liability" being recorded on financial statements (e.g., the 1971 annual report of Sears, Roebuck & Co. shows a $682,389,053 "current tax liability"—really a tax saving primarily from use of the installment sales method for tax purposes). Comprehensive tax allocation and amortization of the investment tax credit over the lives of the assets (rather than flowthrough) make the Federal income tax expense for financial reporting usually much larger (in some cases smaller) than the actual current tax liability.

Comprehensive tax allocation accounting can result in a net current asset ("prepaid" taxes in excess of deferred tax current liabilities) or a net deferred tax current liability (as in Sears, Roebuck & Co. case involving the unpaid tax on the profits in installment accounts receivable), or in a net fixed asset for "prepaid" taxes or a net deferred tax long-term liability (for amounts not expected to reverse in one year). In addition to a net current liability for deferred taxes, the Sears, Roebuck & Co. balance sheet also shows a net long-term or fixed asset for "prepaid" taxes (future tax benefits) probably due to warranty deductions for book purposes being reported before they are deductible for tax purposes and in excess of the long-term liability for tax savings due to accelerated depreciation.

Wherever possible, these deferrals of Federal income tax were taken into account in estimating the current portion of the Federal income tax expense.

Permanent differences (items which do not reverse, e.g., the 85 percent dividend received deduction) are treated the same for financial reporting and for tax purposes. Thus, these items do not result in any differences nor do they affect Federal income tax expenses or liabilities.

Intraperiod tax allocation

This accounting technique shows the effect of taxes on the various sections of the income statement. Thus, extraordinary gains and/or losses are reduced when reported to shareholders by the tax or tax savings attributable to them. Accordingly, in estimating current Federal income tax, an effort was made to reflect the tax effects of extraordinary items where appropriate. For example, where the income statement showed separately a Federal income tax expense and tax savings attributable to a nonoperating extraordinary loss, these items were netted aginst each other for purposes of this study.

This problem is further complicated when the extraordinary gain or loss is recognized for financial reporting in different years than for tax purposes, thus, making comprehensive tax allocation a factor in estimating the current Federal income tax.

Finally, adjustments were also made to the Federal income tax expense shown in the corporation's statements to arrive at an approximation of the tax actually paid or payable for the year involved. This, for example, may have involved the tax effect of using ADR and accelerated depreciation instead of the approach usually shown on the company's statement—namely, the straight-line method on a full useful life. Similarly, adjustments were made for the tax effects of other timing differences such as installment sales or warranties to convert the Federal tax expense shown in the company's statement to an approximate Federal income tax payment for the year involved.

Conclusion

While the six major factors listed above do cause problems and in some cases make it impossible to reliably estimate current Federal income taxes, many companies have only one or two of these complexities; and some companies have excellent financial reporting which makes the estimates of their effective tax rates more reliable.

Other companies have obscured their financial picture to such an extent that both the stockholder and the public are unable to understand how much profit there is—and how much is paid in taxes. The ability of the Congress to debate national economic policy has been crippled by this corporate "number's game."

APPROXIMATE EFFECTIVE FEDERAL INCOME TAX RATES PAID BY COMPANIES SELECTED FROM FORTUNE MAGAZINE'S LIST OF LARGE CORPORATIONS

Corporation	1971			1970			1969		
	Net income before Federal income tax [1]	Approximate current Federal income tax	Effective rate	Net income before Federal income tax [1]	Approximate current Federal income tax	Effective rate	Net income before Federal income tax [1]	Approximate current Federal income tax	Effective rate
Industrial corporation list:									
General Motors	3,252,100	1,566,275	48.2	608,200	[2] 149,418	24.6	------------	(3)	------------
Standard Oil (New Jersey)	------------	(4)	------------	------------	(4)	------------	------------	(4)	------------
Ford Motor	1,094,800	384,800	[5] 35.2	864,600	360,000	[5] 41.6	947,400	347,300	[5] 36.7
General Electric	------------	(6)	------------	490,368	192,100	39.2	448,936	256,300	[20] 57.1
International Business Machines	------------	(4)	------------	------------	(4)	------------	------------	(4)	------------
Mobil Oil	------------	(6)	------------	570,395	95,600	16.8	480,516	34,500	7.2
Chrysler	135,300	[7] 18,800	13.9	(37,800)	[7] (48,000)	------------	169,200	[6] 62,200	36.8
I.T. & T.	413,858	20,247	[8] 4.9	429,615	18,085	[8] 4.2	357,345	51,587	14.4
Texaco	928,689	[2] 30,000	3.2	921,247	[2] 73,250	8.0	887,199	[2] 7,250	.8
Western Electric	478,958	[9] 210,102	43.9	489,089	[9] 221,627	45.3	472,175	[9] 253,409	53.7
Gulf Oil	628,558	[2] 31,062	4.9	625,732	[2] 11,892	1.9	697,643	[2] 4,264	.6
United States Steel	104,516	7,920	7.6	109,491	(66,110)	------------	243,207	5,146	2.1
Westinghouse Electric	257,192	74,754	29.1	199,829	51,675	25.9	273,211	108,884	39.9
Standard Oil (California)	------------	(6)	------------	185,411	29,700	16.0	212,319	10,900	5.1
Ling-Temco-Vought	(39,308)	2,942	------------	(59,948)	3,133	------------	(42,216)	(778)	------------
Standard Oil (Indiana)	423,140	63,462	15.0	417,768	56,018	13.4	412,668	64,524	15.6
Boeing	------------	(6)	------------	9,390	9,000	[20] 95.9	(14,270)	(49,000)	------------
Du Pont	601,600	254,000	42.2	587,700	253,300	43.1	------------	(3)	------------
Shell Oil	------------	(6)	------------	305,298	34,285	11.2	348,263	5,464	1.6
General Telephone & Electronics	------------	(6)	------------	428,639	[4] 176,506	41.2	503,843	[4] 219,206	43.5
RCA	------------	(4)	------------	------------	(4)	------------	------------	(4)	------------
Goodyear Tire & Rubber	263,267	[2] 64,404	24.5	190,229	[2] 40,362	21.2	261,258	[2] 92,891	35.6
Swift	------------	(6)	------------	48,395	[2] 5,666	11.7	------------	(3)	------------
Union Carbide	240,005	44,709	18.6	240,666	49,448	20.6	------------	(3)	------------
Procter & Gamble	397,974	153,828	38.7	389,412	171,294	44.0	342,333	150,165	43.9
Bethlehem Steel	------------	(6)	------------	122,071	[2] (13,000)	------------	169,532	[2] (52,900)	------------
Eastman Kodak	------------	(6)	------------	681,761	270,600	39.7	724,285	318,900	44.0
Kraftco	157,222	65,302	41.5	147,774	65,547	44.4	142,672	65,437	45.9
Greyhound	------------	(6)	------------	64,416	12,387	19.2	68,500	17,766	25.9
Atlantic Richfield	------------	(6)	------------	211,845	10,622	5.0	219,921	3,963	1.8
Continental Oil	109,030	[2] (24,472)	------------	189,377	[2] 9,952	5.3	173,610	[2] (4,189)	------------
International Harvester Co	72,184	25,300	35.1	93,633	24,443	26.1	76,703	19,437	25.3
Lockheed Aircraft	(21)	(21)	(21)	(21)	(21)	(21)	(21)	(21)	(12)
Tenneco	------------	(6)	------------	190,065	24,273	12.8	195,341	25,230	12.9
North American Rockwell	125,534	[4] 59,507	47.4	122,207	[4] 55,713	45.6	------------	(3)	------------
Litton Industries	69,451	[2] 15,648	22.5	100,690	[2] 29,739	29.5	114,822	[2] 29,864	26.0
United Aircraft	(92,572)	[7] 2,428	------------	79,228	[7] 16,260	20.5	------------	(3)	------------

Company	Col 1	Col 2	Col 3	Col 4	Col 5	Col 6	Col 7	Col 8	Col 9
Firestone Tire & Rubber	230,369	[4] 99,334	43.1	172,781	[4] 67,650	39.2	232,252	[4] 106,150	45.7
Phillips Petroleum	161,050	22,984	14.3	146,371	37,687	25.8	156,717	35,279	22.5
Occidental Petroleum	(60,490)	[2] 5,553	---	178,059	[2] 2,457	1.4	176,042	0	0
General Dynamics	---	(6)	---	(3,867)	(38,106)	---	---	(3)	---
Caterpillar Tractor	203,294	[2] 72,658	35.7	241,173	[2] 100,599	41.7	---	(3)	---
Singer	99,887	15,396	15.4	116,818	22,212	19.0	102,562	37,491	36.6
McDonnell Douglas Corp	144,613	[4] (8,087)	(10)	173,170	[4] (46,524)	---	241,133	[4] 40,200	16.7
General Foods	207,305	87,265	42.1	189,793	86,851	45.8	237,240	100,354	42.3
Continental Can	---	(6)	---	143,661	[2] 57,615	40.1	168,738	[2] 66,778	39.6
Monsanto	---	(6)	---	71,303	6,622	9.3	171,979	67,323	39.2
Sun Oil	189,265	[2] 7,445	3.9	192,858	[2] 27,569	14.3	303,180	[2] (2,160)	---
Honeywell	---	(6)	---	95,668	24,867	26.0	108,885	43,243	39.7
W. R. Grace	---	(6)	---	31,507	[4] (4,669)	---	92,109	[4] 29,678	32.2
Dow Chemical	185,129	41,708	22.5	142,793	45,924	32.2	188,896	50,599	26.8
International Paper	80,826	12,479	15.4	40,577	23,586	[20] 58.1	188,714	50,002	26.5
American Can	---	(6)	---	122,425	42,655	34.8	115,325	36,394	31.6
Borden	---	(6)	---	96,443	[4] 31,453	32.6	32,524	[4] (1,998)	---
Rapid American	61,180	20,909	34.2	71,056	24,852	35.0	33,874	7,099	21.0
Burlington Industries	74,820	[2] 35,947	47.4	147,107	[2] 79,007	53.7	152,429	[2] 72,561	47.6
Union Oil of California	---	(6)	---	139,598	7,540	5.4	169,792	8,800	5.2
R. J. Reynolds Industries	---	(6)	---	415,600	[4] 197,116	47.4	362,118	[4] 184,039	50.8
Sperry Rand	116,588	40,700	34.9	146,232	60,050	41.1	---	(3)	---
Xerox	348,576	105,866	30.4	330,116	111,026	33.6	310,522	121,379	39.1
Boise Cascade	---	(6)	---	39,714	2,854	7.2	111,541	17,122	15.4
Cities Service	---	(6)	---	159,472	27,169	17.0	179,633	27,254	15.2
Minnesota Mining & Manufacturing	---	(6)	---	295,886	83,400	28.2	305,715	108,100	35.4
Consolidated Foods	102,819	[2] 38,590	37.5	101,568	[2] 32,761	32.3	97,092	[2] 44,453	45.8
Gulf & Western Industries	51,381	[4] (29,350)	---	56,652	[4] (9,590)	---	97,023	[4] 14,900	15.4
Textron	---	(6)	---	124,236	57,933	46.7	151,672	75,631	49.9
Coca-Cola	---	(6)	---	209,502	[2] 60,050	28.7	194,204	[2] 60,901	31.4
TRW	---	(6)	---	148,278	[4] 65,556	44.2	158,225	[4] 76,504	48.4
Armco Steel	63,052	6,175	9.8	63,744	3,565	5.6	---	(3)	---
Beatrice Foods	115,768	50,564	43.7	111,205	51,946	46.7	---	(3)	---
Ralston Purina	86,429	33,100	38.3	104,770	45,800	43.7	87,753	40,400	46.0
Uniroyal	---	(6)	---	25,726	(3,585)	---	70,474	19,480	27.6
Aluminum Co. of America	50,199	(17,036)	---	106,143	9,112	8.6	170,883	49,848	29.2
American Brands	---	(6)	---	209,062	[2] 88,156	42.2	204,267	[2] 91,073	44.6
Bendix	58,119	10,570	18.2	46,969	17,271	36.8	---	(3)	---
National Cash Register	---	(4)	---	---	(4)	---	---	(4)	---
American Standard	---	(6)	---	(8,802)	(8,068)	---	40,683	(5,179)	---
Signal Co.	26,863	[2] (7,394)	---	(78,388)	[2] 583	---	66,970	[2] (1,951)	---
Ashland Oil	---	(11)	---	---	(11)	---	86,893	27,260	31.4
Owens-Illinois	96,685	23,877	24.7	97,785	35,638	36.5	120,348	45,038	37.4
United Brands	---	(8)	---	(7,961)	(850)	---	34,050	400	1.2
CPC International	---	(6)	---	89,648	24,668	27.5	87,383	25,991	29.7
Standard Oil (Ohio)	---	(6)	---	71,735	(589)	---	94,523	38,841	41.1
Republic Steel	---	(6)	---	18,264	(9,916)	---	127,487	32,389	25.4

See footnotes, p. 26.

APPROXIMATE EFFECTIVE FEDERAL INCOME TAX RATES PAID BY COMPANIES SELECTED FROM FORTUNE MAGAZINE'S LIST OF LARGE CORPORATIONS—Continued

Corporation	1971			1970			1969		
	Net income before Federal income tax [1]	Approximate current Federal income tax	Effective rate	Net income before Federal income tax [1]	Approximate current Federal income tax	Effective rate	Net income before Federal income tax [1]	Approximate current Federal income tax	Effective rate
U.S. Plywood-Chonysion Papers		(6)		47,639	[2] 9,082	19.0	107,688	[2] 35,486	33.0
FMC		(6)		88,130	28,794	32.7	108,699	44,936	41.3
American Home Products		(6)		271,048	[4] 126,683	46.7	254,024	[4] 122,041	48.0
Raytheon		(6)			(4)			(4)	
Warner-Lambert		(6)		150,371	51,942	34.5	143,897	47,684	33.1
Genesco	23,491	[3] 9,328	39.7	37,070	[2] 13,430	36.2	55,907	[2] 23,233	41.6
Allied Chemical		(6)		88,011	[5] 8,336	9.5	84,119	[7] 3,712	4.4
National Steel	73,655	17,600	23.9	73,449	(19,825)		140,115	30,900	22.1
Weyerhaeuser		(6)		170,667	33,460	19.6	185,192	35,930	19.4
U.S. Industries	129,977	47,040	37.6	115,251	41,154	35.7	113,925	48,632	42.7
Getty Oil	138,140	17,062	12.4	121,462	19,725	16.2	117,894	14,682	12.5
Teledyne		(6)		109,312	34,192	31.3		(3)	
Colgate-Palmolive		(4)			(4)			(4)	
B. F. Goodrich		(6)		30,561	[4] 6,090	19.9	66,072	[4] 16,575	25.1
Georgia Pacific		(6)		107,070	4,500	4.2	121,220	21,200	17.5
Whirlpool		(6)		33,345	19,040	[20] 57.1	94,151	46,840	49.8
Transportation corporation list:									
(a) Airline corporations:									
United Air Lines	(7,301)	0	0	(51,168)	(22,850)		87,150	2,933	3.4
Trans World Airlines	(7,128)	0	0	(98,823)	0	0	9,013	(5,415)	
American Airlines	2,404	(75)		(37,552)	(9,874)		45,434	(831)	
Pan American World Airways	(66,033)	0	0	(70,005)	(15,774)		(46,450)	(30,392)	
Eastern Airlines	7,639	0	0	8,073	0	0	(3,521)	0	0
Delta Airlines	43,550	(2,491)		77,165	9,615	12.5	72,298	3,562	4.9
Northwest Airlines		(6)		44,560	[4] (15,280)		80,973	[4] 17,100	21.1
Total for airlines	(27,139)	(2,566)		(127,750)	(54,163)		244,897	(13,043)	
(b) Railroads:									
Penn Central	(22)	(22)	(22)	(22)	(22)	(22)	(22)	(22)	(22)
Southern Pacific	145,675	[12] 19,551	13.4	124,098	[12] 12,049	9.7	142,485	26,718	18.8
Norfolk & Western Ry	62,866	752	1.2	63,305	[13] (2,026)			(3)	
Burlington Northern		(6)		35,663	[14] 1,451	4.1	13,670	(3,486)	
Chesapeake & Ohio		(6)		52,563	3,331	6.3	56,054	804	1.4
Union Pacific		(6)		114,589	(3,835)		123,098	16,840	13.7

Santa Fe Industries		(6)		59,607	4,600	7.7	88,573	6,650	7.5
Southern Ry		(6)		56,474	9,895	17.5		(3)	
Missouri Pacific System	20,932	1,925	9.2	23,135	[15] 553	2.4	23,977	2,686	11.2
Total railroads	229,473	22,228	9.7	529,434	26,018	4.9	447,857	50,212	11.2
(c) Trucking companies:									
Consolidated Freightways		(6)		13,156	[4] 6,928	52.7	26,779	[4] 11,639	43.5
Leaseway Transportation	26,129	4,793	18.3	1,483	(3,105)		12,719	1,885	14.8
Roadway Express [16]	34,572	18,931	54.8	17,606	8,573	48.7		(3)	
Yellow Freight System	24,260	[4] 10,897	44.9	13,773	[4] 5,135	37.3	14,639	[4] 5,584	38.1
Total trucking	84,961	34,621	40.8	46,018	17,531	38.1	54,137	19,108	35.3
Utility corporation list:									
A.T. & T.	3,498,478	[17] 1,138,474	32.5	3,561,809	[17] 1,478,656	41.5	4,014,369	[17] 1,848,301	46.0
Consolidated Edison	202,228	[18] 6,727	3.3	110,027	[18] (17,500)		141,389	7,200	5.1
Pacific Gas & Electric		(19)			(19)			(19)	
Commonwealth Edison		(6)		195,940	53,127	27.1	220,374	74,424	33.8
American Electric Power	149,876	6,722	4.5	136,662	18,051	13.2	138,457	31,814	23.0
Southern California Edison	159,824	35,409	22.2	160,407	35,840	22.3	139,933	34,430	24.6
Columbia Gas System	119,659	28,077	23.5	129,666	43,592	33.6	122,254	41,352	33.8
El Paso Natural Gas	87,854	23,908	27.2	33,034	6,644	20.1	51,337	14,399	28.1
Texas Eastern Transmission	101,768	26,362	25.9	81,424	18,991	23.3	60,877	8,478	13.9
Pennzoil United		(6)		74,719	(12,755)		65,700	6,835	10.4
Retailing corporation list:									
Sears & Roebuck	682,148	289,306	42.4	694,394	292,308	42.1		(3)	
Allstate and subsidiaries	90,775	5,327	5.9	82,910	(265)				
Great Atlantic & Pacific Tea	89,437	33,883	37.9	100,666	41,750	41.5	84,736	32,820	38.7
Safeway Stores	155,127	[2] 75,328	48.6	140,441	[2] 69,893	49.8	113,347	[2] 55,563	49.0
J. C. Penney	216,605	72,509	33.5	225,482	86,182	38.2	230,305	100,617	43.7
Kroger	56,522	21,462	38.0	74,366	32,839	44.2	68,693	28,105	40.9
Federated Department Stores	154,669	68,798	44.5	169,942	80,832	47.6	162,270	77,398	47.7
Commercial banking list:									
Bank America Corp		(6)		239,758	[4] 75,880	31.7	249,416	[4] 97,203	39.0
First National City Corp	281,559	[4] 80,486	28.6	222,175	[4] 43,557	19.6	184,782	[4] 31,174	16.9
Chase Manhattan Corp		(6)		163,619	[4] 42,445	25.9	150,065	[4] 55,131	36.7
Manufacturers Hanover Corp		(6)		142,573	[4] 49,870	35.0	132,084	[4] 56,264	42.6
J. P. Morgan		(6)		132,690	[4] 36,386	27.4	115,430	[4] 35,482	30.7
Western Bancor		(6)		70,097	[4] 10,856	15.5	94,241	[4] 22,300	23.7
Chemical New York Corp	102,073	[4] 31,734	31.1	102,675	[4] 33,967	33.1	99,406	[4] 39,174	39.4
Bankers Trust New York Corp		(6)		83,903	[4] 28,236	33.7	52,731	[4] 11,899	22.6
Conill Corp	100,257	[4] 25,513	25.5	77,922	[4] 17,794	22.8	58,685	[4] 11,473	19.6

See footnotes, p. 26.

[1] The adjusted net income before Federal income tax reported to shareholders consists of the net income (or loss) plus all Federal income tax expense (or income) plus deductions for minority interest taken in calculating net income and less income from an investment in another company when the equity method of accounting has been used. In some cases, the minority interest and/or the income reported under the equity method was not separately disclosed; thus, in these cases, these adjustments could not be made. (These accounting problems are further explained in the appendix.)

[2] The deferred income tax accounts (tax effect of timing differences) may contain State and local and/or foreign in addition to Federal income taxes. Thus, this might have a significant effect on the estimated current Federal income tax and percentage.

[3] All the data necessary to compute the result for 1969 were not available on the 1971 and/or 1970 financial statements.

[4] Possibly overstated significantly because foreign and/or State and local income taxes are combined with Federal income tax. Wherever this is believed to be extremely significant, the data are omitted. These companies have not reported separately their Federal income tax expense. As stated elsewhere, this is an apparent violation of SEC filing requirements.

[5] The Ford Motor figures represent the effects of State and local as well as Federal income taxes. Their reports combine these amounts and thus the percentages are higher.

[6] The data for 1971 were not available when this information was being gathered.

[7] Including Canadian and U.S. income tax.

[8] Even though there appears to be some tax paid, the 10-K for ITT indicates that Hartford and ITT filed consolidated tax returns on which no tax was paid.

[9] Western Electric Co.'s income is included in the consolidated return for the Bell System; however, this is essentially the same tax which would have been reflected if a separate return were filed.

[10] McDonnell Douglas Corp.'s 1971 10-K indicates a NOL carryforward from 1970 and 1971; thus, in effect, no Federal income tax has been paid since prior to 1961.

[11] The 1971 and 1970 data for Ashland Oil were not readily available in the SEC microfilm files.

[12] The 10-K report states that Southern Pacific had no tax liability on a consolidated return for either 1971 or 1970; the results for 1969 were not disclosed. The estimated amounts for Federal income tax ($19,551,000 for 1971 and $12,049,000 for 1970—effective tax rates of 13.4 and 9.7 percent, respectively) if actually paid may have been paid by subsidiaries less than 80 percent owned and, thus, not eligible to be included in the consolidated tax return. Some, or all, of these amounts may represent overstatement of Federal income tax accrud accounts in order to provide a reserve for future tax deficiencies following audits by the IRS; to this extent they would not be paid.

[13] The Analysis of Federal Income Taxes (p. 316 of their 1970 ICC annual report) showed that Norfolk & Western saved $29,403,000 in Federal income tax due to accelerated depreciation and to 5-year amortization. Their Federal income tax, if based on income per books of account would have been $39,632,000. Filing a consolidated return saved an additional $16,687,000 in Federal income taxes. Their minimum tax on preferences was $2,143,000; however, the analysis of Federal income taxes indicated a refund of $1,624,000. The 1970 net income (after provision for Federal income tax and after providing for minority interests) was $71,259,000 for Norfolk & Western and $64,017,000 consolidated.

[14] The 1970 ICC annual report (p. 316, "Analysis of Federal Income Taxes") showed that Burlington Northern saved $12,236,000 due to accelerated depreciation. Their taxes based on income recorded in the accounts would have been $13,367,000. Their refund was $603,603. The net income (after provision for Federal income tax and after reflecting minority interests) for Burlington Northern was $33,000,000 and $34,202,000 consolidated.

[15] The 1970 Analysis of Federal Income Taxes (p. 316 of their ICC annual report) indicated that Missouri Pacific had a refund of $314,700. Their Federal income tax based on taxable income as recorded in the accounts for financial reporting would have been $6,671,000 The net income (after provision for tax) was $18,189,000 for Missouri Pacific and $21,580,000 when consolidated. This company saved over $3,000,000 in taxes in 1970 due to accelerated depreciation and 5-year amortization.

[16] The information for Roadway Express was taken from its 1971 annual report to shareholders.

[17] Because the wholly owned subsidiary Western Electric Co. is accounted for by using the equity method, the income and current Federal income tax for A.T. & T. is not included here even though a consolidated tax return is filed.

[18] Notes to the financial statement of Consolidated Edison indicate net operating losses for tax purposes for both 1970 and 1971 while the 1971 net income reported to shareholders was the highest in any of the prior 10 years of the company's history. Dividends paid were $102,065,000, 1969; $108,-021,000, 1970; and $119,406,000, 1971. None of the dividends on the common stock for these 3 years (amounted to $31,188,234 and $73,436,126 for 1971 and 1970) were taxable as dividend income.

[19] Due to undisclosed amounts of intraperiod tax allocation, the total Federal income tax provision cannot be ascertained for Pacific Gas & Electric.

[20] This high effective rate for Whirlpool may have been the result of expenses being taken for book purposes which are not deductible for tax purposes (e.g., goodwill).

[21] Due to huge losses, this company has not been included.

[22] This company has been eliminated due to huge losses.

Note: The study is based entirely on information from public sources, including 10-K reports, registration statements, and prospectuses filed with the Securities and Exchange Commission as well as annual reports to shareholders and annual reports to the Interstate Commerce Commission.

APPROXIMATE EFFECTIVE RATES OF CORPORATE FEDERAL INCOME TAX FOR STEEL COMPANIES

Corporation	1971			1970			1969		
	Net income before Federal income tax [1]	Approximate current Federal income tax	Effective rate	Net income before Federal income tax [1]	Approximate current Federal income tax	Effective rate	Net income before Federal income tax [1]	Approximate current Federal income tax	Effective rate
Companies:									
United States Steel	104,516	7,920	7.6	109,491	(66,110)		243,207	5,146	2.1
Bethlehem Steel		(3)		122,071	[2] (13,000)		169,532	[2] (52,900)	
Armco Steel	63,052	6,175	9.8	63,744	3,565	5.6		(4)	
Republic Steel		(3)		18,264	(9,916)		127,487	32,389	25.4
National Steel	73,655	17,600	23.9	73,449	(19,825)		140,115	30,900	22.1

[1] The adjusted net income before Federal income tax reported to shareholders consists of the net income (or loss), plus all Federal income tax expense (or income) plus deductions for minority interest taken in calculating net income and less income from an investment in another company when the equity method of accounting has been used. In some cases, the minority interest and/or the income reported under the equity method was not separately disclosed; thus, in these cases, these adjustments could not be made.

[2] The deferred income tax accounts (tax effect of timing differences) may contain State and local and/or foreign in addition to Federal income taxes. Thus, this might have a modest effect on the estimated current Federal income tax and percentage.

[3] The data for 1971 were not available when this information was being gathered.

[4] All the data necessary to compute the result for 1969 were not available on the 1971 and/or 1970 financial statements.

Note: The study is based entirely on information from public sources, including 10—K reports, registration statements, and prospectuses filed with the Securities and Exchange Commission as well as annual reports to shareholders and annual reports to the Interstate Commerce Commission.

APPROXIMATE EFFECTIVE RATES OF CORPORATE FEDERAL INCOME TAX FOR OIL COMPANIES

Corporation	1971			1970			1969		
	Net income before Federal income tax [1]	Approximate current Federal income tax	Effective rate	Net income before Federal income tax [1]	Approximate current Federal income tax	Effective rate	Net income before Federal income tax [1]	Approximate current Federal income tax	Effective rate
Standard Oil (New Jersey)		(2)			(2)			(2)	
Mobil Oil		(3)		570,395	95,600	16.8	480,516	34,500	7.2
Texaco	928,689	30,000	3.2	921,247	73,250	8.0	887,199	7,250	.8
Gulf Oil	628,558	31,062	4.9	625,732	11,892	1.9	697,643	4,264	.6
Standard Oil (California)		(3)		185,411	29,700	16.0	212,319	10,900	5.1
Standard Oil (Indiana)	423,140	36,462	15.0	417,768	56,018	13.4	412,668	64,524	15.6
Shell Oil		(3)		305,298	34,285	11.2	348,263	5,464	1.6
Atlantic Richfield		(3)		211,845	10,622	5.0	219,921	3,963	1.8
Continental Oil	109,030	(24,472)		189,377	9,962	5.3	173,610	(4,189)	
Tenneco		(3)		190,065	24,273	12.8	195,341	25,230	12.9
Phillips Petroleum	161,050	22,984	14.3	146,371	37,687	25.8	156,717	35,279	22.5
Occidental Petroleum	(60,490)	5,553		178,059	2,457	1.4	176,042	0	0
Sun Oil	189,265	7,445	3.9	192,858	27,569	14.3	203,180	(2,160)	
Union Oil of California		(3)		139,598	7,540	5.4	169,792	8,800	5.2
Cities Service		(3)		159,472	27,169	17.0	179,633	27,254	15.2
Standard Oil (Ohio)		(3)		71,735	(589)		94,523	38,841	41.1
Getty Oil	138,140	17,062	12.4	121,462	19,725	16.2	117,894	14,682	12.5
Total	2,517,382	153,096	6.1	4,626,693	467,160	10.1	4,725,261	274,602	5.8

[1] The adjusted net income before Federal income tax reported to shareholders consists of the net income (or loss), plus all Federal income tax expense (or income) plus deductions for minority interest taken in calculating net income and less income from an investment in another company when the equity method of accounting has been used. In some cases, the minority interest and/or the income reported under the equity method was not separately disclosed; thus, in these cases, these adjustments could not be made.

[2] Possibly overstated significantly because foreign and/or State and local income taxes are combined with Federal income tax. Wherever this is believed to be extremely significant, the data has been omitted.

[3] The data for 1971 were not available when this information was being gathered.

Note: The study is based entirely on information from public sources, including 10-K reports, registration statements, and prospectuses filed with the Securities and Exchange Commission as well as annual reports to shareholders and annual reports to the Interstate Commerce Commission.

Chairman PROXMIRE. Well, I want to thank you very much, Congressman Vanik, for a remarkable job. I do not know any Member of the House or Senate who has ever done the kind of thorough and comprehensive study that you have done of our tax system, and go into such detail. You say it comes from public sources, but nobody has put it together before, to the best of my knowledge, and shown this remarkable differential between corporations, some of which pay relatively high taxes and some of which pay very low taxes, some of which make profits and pay no taxes at all. I think it is a very helpful revelation and, as you say, it certainly does underline the desirability and necessity for a much harder, clearer look at our tax structure than we have had before.

I would like to ask, though, to put all this in perspective, in your view, what happens when corporate income taxes are reduced or even when they are reduced to individual corporations? I am not sure that you have the same kind of direct unfair distribution of income that you might have with similar treatment of personal income taxes. You are being followed by Michael Harrington, a very able economist and analyst, who argues that he would abolish the corporate income tax entirely. No corporation would pay any income taxes. And he, of course, has strong value judgments in the area of redistributing wealth. He would rely entirely on the personal income tax.

Representative VANIK. The problem with that is the theory that they would pay taxes on their dividend incomes. But I refute that dividend incomes make much of a contribution to the tax revenues of the country. If some three individuals can make $7.5 million in income and pay no taxes, how much revenue are we getting to the Government?

Chairman PROXMIRE. I am sure I do not want to get into the subsequent witness' views, but the problem is because of weaknesses in the personal income tax structure.

As far as corporate income taxes are concerned many economists argue—Harold Groves, for example, of the University of Wisconsin—that the main burden of corporate income taxes is on the consumer. That is, as you increase the corporate income taxes, corporations pass the tax increase on to consumers in higher prices, and a reduction in taxes is passed on in lower prices.

Representative VANIK. All I want to say to that is, I consider the taxpayer a person, a citizen, and as such, he should be expected to make some contribution to the cost of running the country.

Chairman PROXMIRE. There is no question that the incidence of the tax on consumers isn't complete, and stockholders and employees may share at least part of the cost.

When you show a very low corporate income tax or no tax on income, you mean that with foreign taxes paid deducted as a credit, and with the investment credit enabling them to subtract 7 percent of their investment against any tax liabilities, that they can reduce their taxes sharply in some cases. Why doesn't this simply mean that some of these corporations have heavy investments abroad and pay very heavy taxes abroad, and some of these corporations are making intensive investments in improving their efficiency and productivity and in doing so are improving their productivity, which is the purpose of investment credit?

Representative VANIK. Well, that is precisely the point that I made, that I said is not supported by the evidence. My findings are that the investments abroad create employment abroad rather than employment in the United States; that it has not resulted in any substantial employment benefit to the people of the United States.

The other point is that the corporations involved, like the multinationals——

Chairman PROXMIRE. How do you know that? How do you know it has not resulted in increased employment? Employment has gone up sharply in recent years.

Representative VANIK. In those industries where we have used tax impetus to stimulate employment, we have found that it has not worked out. The revenue we lost, for example, in the investment credit is not borne out—I have just pointed out there has been a job decrease.

Chairman PROXMIRE. Yes, but you see, this may be where you are focusing, and I may be wrong, but I think you are focusing on the industries that have bought additional equipment to take advantage of the investment credit. You say they have not increased employment, and that is correct. What they do, of course, is automate and they reduce their own need for employment. The increase in employment is in the machine tool industry and the other industries providing equipment. In my own State of Wisconsin, which is very heavy in machine tools, they have shown me how, as the investment credit has been applied, they have had a very sharp increase in employment and as it has been cut back, they have had a sharp drop.

Representative VANIK. I would like to put in the record a report I have from the Department of Labor on the statistics of the automotive industry and also machinery manufacture. That shows a decline from 1971 to the present.

Chairman PROXMIRE. A decline in the machine tool and employment?

Representative VANIK. Machine manufacture.

Chairman PROXMIRE. I would want to know how comprehensive those studies are.

Representative VANIK. This is the unemployment, Mr. Chairman. The total employment has not risen. Unemployment has gone the other way.

Chairman PROXMIRE. Total employment has not risen in the automobile industry. I am aware of that.

Representative VANIK. And it has not risen in the machine tool industry.

Chairman PROXMIRE. Same thing?

Mr. PEDLEY. In the Nation as a whole.

Chairman PROXMIRE. That is a very good point. What years do you have?

Representative VANIK. We have the years 1971 and 1972, the effective years, beginning with January 1971. I had this table computed out by the Department of Labor and it shows exactly the reverse.

Chairman PROXMIRE. All right. If you have that, it is a very good point. Without objection, the table will be placed in the record at this point.

(The table referred to follows:)

HOW EFFECTIVE HAVE PAST TAX CUTS BEEN IN REDUCING UNEMPLOYMENT?

DEPARTMENT OF LABOR STATISTICS ON AUTOMOTIVE INDUSTRY

[Note: We were told that an extra 25,000 men would be employed for every extra 100,000 cars produced. It has been a great car year, but total employment and unemployment in the auto industry have been fairly stable]

	Employed	Unemployed		Employed	Unemployed
January 1971	1,095,000	50,000	October 1971	1,046,000	36,000
February 1971	1,069,000	73,000	November 1971	1,048,000	41,000
March 1971	1,060,000	53,000	December 1971	1,060,000	43,000
April 1971	991,000	69,000	January 1972	1,025,000	56,000
May 1971	1,024,000	49,000	February 1972	992,000	61,000
June 1971	1,011,000	35,000	March 1972	1,026,000	52,000
July 1971	984,000	94,000	April 1972	1,021,000	41,000
August 1971	1,034,000	[1] 70,000	May 1972	1,058,000	51,000
September 1971	1,126,000	57,000	June 1972	1,055,000	51,000

MACHINERY MANUFACTURE (MINUS ELECTRICAL): WHAT EFFECT INVESTMENT CREDIT?

	Employed	Unemployed		Employed	Unemployed
January 1971	2,076,000	156,000	October 1971	1,971,000	100,000
February 1971	2,043,000	158,000	November 1971	1,962,000	106,000
March 1971	2,060,000	174,000	December 1971	1,937,000	105,000
April 1971	1,959,000	164,000	January 1972	1,973,000	109,000
May 1971	1,991,000	155,000	February 1972	1,994,000	116,000
June 1971	1,980,000	147,000	March 1972	2,015,000	134,000
July 1971	1,913,000	141,000	April 1972	1,985,000	96,000
August 1971	2,003,000	108,000	May 1972	1,952,000	124,000
September 1971	1,984,000	79,000	June 1972	2,022,000	74,000

[1] Announced excise removal.

Note: While unemployment is down among machinists, total employment is about where it was—in fact lower—than in January 1971.

Chairman PROXMIRE. You stated and I quote: "I believe we should seek to establish equal treatment in U.S. taxes by treating foreign taxes as a cost of doing business for which one may obtain a deduction, not a credit."

In other words, you are saying that the U.S. corporate income taxes are somehow more valid or for some reason deserve a higher priority than foreign governments' taxes on corporate income. How can you justify that attitude of placing U.S. national sovereignty in a position that is superior to the tax-levying sovereignty of other countries?

Representative VANIK. In the first place, I think our tax should be paramount. I think it is ridiculous that foreign governments should find ways of getting more money out of our industries than we do.

Chairman PROXMIRE. It is reciprocal, is it not? In other words, if we have our corporations go overseas and are taxed there; foreign corporations come over here in this country and operate, we tax them. Are those not a credit, in many cases?

Representative VANIK. I just can't reconcile your point of view on that with my own. My own point of view is if Brazil, for example, or Venezuela, is able to take more income taxes out of an American company than we do, something must be terribly wrong with the American tax system. Because the great operations of the company are here.

Chairman PROXMIRE. If they are here, I think that is correct. If you can document that, that will be helpful. But my point is that if much of the activity is abroad; and the profit is abroad; and the employment is abroad; and the investment is abroad; then it is perfectly proper under those circumstances for them to pay their taxes in the country where they operate and where they receive the protection of the government and where they receive the services of the government and where they are paying taxes for those services.

Representative GRIFFITHS. Where are the sales?

Representative VANIK. The sales are in the United States.

Representative GRIFFITHS. Of course, they are in the United States.

Chairman PROXMIRE. Well, the sales may be another criterion. Perhaps under those circumstances, there should be a corporate income tax in the form of a sales tax, of course. I think many economists feel the incidence is shared or paid for by the consumer. You could have a sales tax and collect it all in this country.

Representative VANIK. U.S. Steel is an example. Let's talk about one company we know about.

Chairman PROXMIRE. I am told by the staff the sales are not largely in the United States.

Representative VANIK. U.S. Steel, for example, has vast operations in this country. It operates, it is a burden on the community. It provides jobs here, but there is also a burden on the community. We have to protect it, we have to take care of the environmental problems, et cetera. Yet I think Venezuela managed to collect more taxes from the company than the United States, the Government of Venezuela. So it seems to me there must be something radically wrong with a tax system which permits the foreign governments to take more Federal revenue, more tax revenue, from a company that is principally operating, substantially conducting most of its industrial operations in the United States.

Chairman PROXMIRE. I think you can make a devastating case in the oil situation where you have royalties imposed. For years those were considered as a cost of doing business. Now through the golden gimmick, they are used as a deduction from taxes. I am not so sure, however, when it comes to taxes that are imposed on other industries. If an industry, it seems to me, is operating in a country and requires the protection of that country and a legitimate tax is imposed, then it seems to me you can make a strong case that that tax should be imposed as a tax credit, as taxes in this country, by the jurisdiction of the Federal Government.

Representative VANIK. I would say again, Mr. Chairman, that the facts are so difficult to get at that I would say that unless we have more facts, we cannot clear up that issue. I do think a stronger case is made for those operations that are conducted generally for overseas production and consumption.

Chairman PROXMIRE. I see; my time must be about up.

I want once again to thank you very much, Congressman Vanik, for an extraordinary piece of work that is a real contribution here. I am sure it is going to be very helpful.

As you indicate in your responses to my questions, it is going to take a long time for us to analyze this and get it into our understanding so that we can have a report that will be fair and constructive and useful. But it is a fine job.

Representative VANIK. Mr. Chairman, if I might just respond, I want to state that I certainly appreciate that your committee has led the way. I think we are dealing with the vital questions of American life in the role of free enterprise and its opportunity to compete equally and evenly with everyone else.

But I would just like to say one thing. We are in a vicious cycle. We cannot change or remake the tax laws without facts and we cannot obtain essential facts because of laws that cloud and conceal the truth to which every citizen is entitled. There can be no decent measure of tax justice when facts are buried and needlessly protected by archaic laws. What the public does not know and can't know can indeed hurt every citizen. This is the one thought that I want to convey to you at this point, that our great problem on the Ways and Means Committee, and I know your problem, has been one of getting the essential facts that I think our committee should have in order to arrive at sound judgments.

Chairman PROXMIRE. Before I yield to Congressman Reuss, let me say this committee is going to take the material you have and we are going to ask the Council of Economic Advisers, the U.S. Treasury, the Securities and Exchange Commission, and other agencies that have responsibility in this area to analyze it and give us their best judgment on information that raises serious question about the inequity and unfairness and lack of revenue generation of our present income tax system.

Representative VANIK. Thank you.

Chairman PROXMIRE. Mr. Reuss.

Representative REUSS. To be delivered out by November 10, 1972?

Chairman PROXMIRE. Oh, no, at least 3 weeks before the election.

Representative REUSS. Thank you, Mr. Chairman. I share your gratitude to Congressman Vanik for his superb job this morning. He brings expertness that he has gathered from long years on the Ways and Means Committee to our forum.

I would like to enter the colloquy you just had with Mr. Vanik about the effect of the foreign tax credit.

Take a Wisconsin company, Allen Bradley, for example, which is debating whether to close down an electronics operation in Milwaukee and transfer it overseas, to Mexico or other countries—Korea, Taiwan, and so on. Look at the tax calculus facing management in that case. If they operate a plant in Wisconsin, their Wisconsin corporate income tax at the effective rate of about 12 percent, a rather steep one, is merely a deduction from their Federal income tax. Only 48 percent of it, therefore, stays in the corporate coffers.

If, on the other hand, they set up shop overseas, under the tax credit system, they can deduct every penny of foreign income tax. Does that not—I will ask Mr. Vanik, though you may wish to comment, Mr. Chairman—rather skew the corporate decisionmaking process, and is that not perhaps one of the factors which have led so many people to believe that an export of jobs is going on, and which has led, of course, to the very unfortunate Burke-Hartke bill, which would carry in its train some consequences which I personally find very undesirable.

What about that, Mr. Vanik?

Representative VANIK. I heartily agree.

But I think what you suggested by way of job export is a logical, believable concept after you analyze what specifically happens.

Representative REUSS. A businessman says, well, if I open a plant in Cleveland or Detroit or Milwaukee, I will just be able to deduct the State tax that I pay, whereas if I open one across the Rio Grande or in Taiwan, I will get a credit; therefore, since my head is screwed on, I will jump ship and open it in Mexico.

Representative VANIK. I think Professor Musgrave in his report substantiates what you have just said.

Representative REUSS. In her report.

Representative VANIK. In her report, yes.

Representative REUSS. Mr. Vanik, as I said, you are an industrious member of the House Ways and Means Committee. What is the Ways and Means Committee doing right now about closing tax loopholes?

Representative VANIK. Well, I am here because I want to stimulate action by my committee. I have tried internally with my good colleague, Mrs. Griffiths. We are trying to do everything we can to precipitate committee action. The legislative calendar is difficult. But one of my purposes here today is to help keep pressure on, help urge and stimulate action by my committee to legislatively do some of the things which I think would be substantiated and called for by your very careful analysis here.

Representative REUSS. In the Wall Street Journal this morning is a story I would like to have you confirm or deny, that the Ways and Means Committee currently—right now—instead of being engaged in plugging some of the loopholes which have made a shambles of our tax system, is engaged in working up an omnibus bill, putting in not just one but a whole string of loopholes—a so-called members bill in which everyone gets one bite.

Can you confirm or deny that?

Representative VANIK. Such a bill is under discussion, but my vote will be cast to break it up and make every single item in that bill stand for a vote in the House. I don't know whether I am going to be successful in that, but I am certainly going to make every effort I can to be sure every one of these issues can be separately resolved by way of separate legislation.

Representative REUSS. Could I not ask you to go just one step further, that instead of voting these loopholes one by one you vote against these loopholes?

Representative VANIK. Oh, I certainly will. That is implied. You have been urging me to do things for some time now and I have been very diligent in following through. I must say I certainly do expect and my opposition will certainly be registered on a rollcall vote against any legislative effort of that kind. It would be contrary to every reason I have been on the Ways and Means Committee for me to do otherwise.

Representative REUSS. I do not believe you specifically mentioned, in connection with the taxation of American multinational corporations, the deferral of Federal income tax on income not repatriated. Did you mention deferral, too?

Representative VANIK. It is completely reported in my comprehensive prepared statement, which is in the record.

Representative REUSS. And is it your feeling that that, too, needs reexamination?

Representative VANIK. Yes, sir; I heartily agree with you. You and I are in full agreement on that issue. That continues in the full pre-

pared statement that I have submitted for the committee, which I had to condense in the time allocation.

Representative REUSS. Thank you very much.

Chairman PROXMIRE. Mrs. Griffiths.

Representative GRIFFITHS. I have no questions. You did a very good job.

Representative VANIK. Thank you, Mrs. Griffiths.

Chairman PROXMIRE. Thank you, Congressman Vanik, for a very fine job. We are delighted you came before us and you have certainly given our hearings on the tax system an excellent send off.

Our next witness is Mr. Irwin Miller. I understand Mr. Harrington will come forward also.

Mr. Miller is chairman of the board of Cummins Engine Co. He holds degrees from Yale and Oxford. Mr. Miller is also chairman of the board of Irwin Union Bank and Trust Co. in Columbus, Ind., and is director of the American Telephone and Telegraph Co. as well as the Chemical Bank. In 1967–68 Mr. Miller was a member of the President's Committee on Urban Housing and of the President's Commission on Urban Housing.

Mr. Michael Harrington is a well-known author, perhaps best known for "The Other America," published in 1963 and his most recent book, "Socialism." Mr. Harrington has long been a spokesman for fundamental economic reforms. He has served on the board of directors of the Workers Defense League of the American Civil Liberties Union, and is chairman of the League for Industrial Democracy.

Gentlemen, we are delighted to have you. You understand the rules of the committee. As I say, I wish we did not have to have the limitation on time. You both have fine prepared statements. Your entire prepared statements will be printed in full in the record.

Mr. Miller, go right ahead. You have 10 minutes.

STATEMENT OF J. IRWIN MILLER, CHAIRMAN OF THE BOARD, CUMMINS ENGINE CO.

Mr. MILLER. Thank you, Senator. I would like to begin by associating myself with your opening remarks that thorough going tax reform on a sophisticated, intelligent basis is long and dangerously overdue.

I would also like to associate myself with some of Congressman Vanik's remarks; that is, that in beginning to look at tax reform which will be effective for as complicated a country as we are, the Congress does not have available adequate facts or analysis capability. I can be very sympathetic with Congressman Vanik's obvious frustration in trying to sort out his data. I think, however, it is therefore very dangerous to jump to dramatic conclusions if one is nervous about one's facts.

One of the companies he mentioned made $26 million in 1971 and paid no tax. Just by chance, I noticed that their company had also lost $78 million the previous year, and so it was not inappropriate that loss carry-forward has something to do with its first year of recovery. Such things have to be taken into account before one jumps to conclusions.

Another example: In the banking world, there will be different types of taxes paid according to whether a bank decides to invest heavily in municipal bonds, which are tax free, or Government bonds. You will have to take up the whole business of the tax free character of municipal bonds not in respect to any one owner but in respect to the whole system and all the tradeoffs for the whole American public.

Now, this leads me to my first point, which may seem to be an obvious one, but I feel very strongly about it because I really do not see anything being done about it. As a businessman, I think most of us wish that the Congress had enormously more staff available to them. And we would support your efforts to get competent staff. Having served on five Government commissions, I was amazed at the lack of factual information—not the lack of facts, but the lack of factual information on which you could depend in deciding the affairs of this country.

I do not think the Congress has available today the facts it needs to make wise tax reform. In addition, after getting those facts, Congress then has to develop a sophisticated systems analysis capability, which it does not have now. Finally it needs to develop national modeling ability, not only on taxes but on the nontax alternatives as well.

All this then needs then to be tested against agreed-upon national priorities and some sort of national, regional, and local planning to carry it out. Only then will you be able to determine the tradeoffs in as complex a country as we have and decide what all the effects of your decisions are going to be.

My second point, is that it is very dangerous to talk of one tax as a good or bad tax. We have a system of taxes, not a collection of taxes, and the interactions of those systems are vital to the progress of the country.

The next point that you have to face is that you are going to have to raise taxes by a substantial amount, by an amount enough to affect all of us. I think that this country is slipping backwards in respect to the important services. We are the most affluent society that history has seen, and yet nearly all of our great social services are bankrupt. We ought to ask what is affluence for except to provide these services in greater quality to more people—I include defense, health, education, environment, transportation—all of them.

When you consider that there are going to be 175 million more people here in only 20 years, a nation as large as France and maybe West Germany put together, we should be underway right now. This means to me that after all of the economies are made, after all of the unnecessary programs are pruned out, you are going to have to raise a gross amount of taxes greater than the present amount and I think that has to be a major consideration in the work of this committee.

How is this greater amount of taxes then to be collected? Well, first of all, I think Congress has to couple the cost to the expense. When I served on the Postal Commission, it was very clear to me that a principal reason for the postal deficit was that the people who set postal rates had no responsibility for postal expenses and the people who set the wages had no responsibility for the rates, and the deficit fell between the cracks. Someone in this Government has got to decide, is a

service worth the tax that you levy for it or not? They have to be coupled together when you are talking about tax reform, particularly when you are considering specific taxes for specific reasons.

Next, if you then are going to have to have more taxes, what about the collection of those? In my opinion, equity must be a paramount consideration. My own studies of the tax system for the last 20 years, and admittedly they are not comprehensive, tell me that there is reason for the taxpayers' revolt, and that the system is becoming more regressive. For instance, I think probably I am getting off too easily. If we have a considerable amount of inequity in the tax system, then we are going to inhibit the growth of the country, because we will end up with frustration, hostility, and cross purposes.

I think that in all of the treatment of incentives, we have not paid enough attention to the fact that maldistribution also hinders growth. In respect to maldistribution, it can be of two natures. One relates to how the tax is collected and one to how it is spent. The way in which the benefits flow can also affect the maldistribution of wealth and the committee has to take that into account as well in working out the fairness of the system.

As you work on equity, you must aim to make a reality out of equality of opportunity in this country. There is no justification for any new baby born in this society to have inadequate diet, inadequate education, inadequate health care. It was not his fault that he was brought into the world. Equality of opportunity means—if nothing else—an equal chance at the starting line. And that is part of the reason for the increase in taxes. And it is something to which you will have to address yourselves.

Now, I will condense my remaining remarks, because I would rather leave more time for you to ask any questions.

The second thing I think you have to address is that any tax system we have is inescapably a system of incentives. Congressman Vanik has just demonstrated this because he has dramatically illustrated how many of the incentives, either intended or unintended, have worked. I think that the committee ought to recognize explicitly that any system of taxes will inevitably have incentives, and that the important thing is to line those incentives up with the national purpose. Some of our incentives today are contrary to the national purpose, and so we set up regulatory agencies to force people to act against their economic interests. If we line the economic interest up with the national purpose, the job of regulation would be automatically very much simpler.

One of the particular items in the incentives that I think you should look long and carefully at is the charitable deduction. My company does business in nearly every nation of the world. It is very clear to me that in no nation do so many people give so much time, labor, and money to their communities and to local and national causes. The people of the United States accept an enormous responsibility personally for their society. The charitable deduction has encouraged this. Its abuses obviously ought to be curtailed. But if in doing so, you remove the encouragement for people to give, then you will encourage people to be less concerned and less involved in their society and the alienation from the State will proceed. And I think this is

one of the great glories of this country, the degree to which our people feel a responsibility for their own communities and Nation.

Now, finally, I think that new types of incentives ought to be considered. One very interesting one exists in the United Kingdom. The United Kingdom collects from the company a tax of a certain amount for each employee that it has on its payroll. The government does not intend to keep this money. The company may get the tax back provided it institutes an approved apprentice training program, and you may get it back up to the full amount that was taken away from you. The result of this is that there is more intelligent training of young men and young women in industry in the United Kingdom than here by far. That tax is a wash and it has been accomplished without any massive government funding. There are techniques like this that you ought to take account of, in other nations as well as in our own.

Now, finally, I would like to make a plea that the tax system ought to be less rigid than it is. The only degree of flexibility to handle swift changes in the economy is in the monetary area and that now has been strained several times in the last 10 years. I think some fiscal flexibility should also be introduced for the executive. I could conceive of the Congress, instead of legislating specific tax rates, legislating a range of tax rates within which the executive could operate, perhaps subject to a veto by the Congress in a certain period of time. I think that the executive would be better able to handle sudden shifts in the economy if there were flexibility both in the fiscal and in the monetary areas.

And finally, I would like to agree with you that the whole tax system needs to be simplified, made comprehensible to the taxpayer, and to be reshaped so that we can make sure we collect all the taxes. I do not know what the yield on taxes is. I suspect that improvement could probably be made if we had a tax system that was easier to administer, check, and easier to make out for the taxpayer.

So that is a summary of my remarks. I am a strong proponent of what you are trying to do. I only plead that you begin now to develop the kind of competence and national sophistication that the Congress of the year 2000 will wish you had started on this year.

Thank you.

(The prepared statement of Mr. Miller follows:)

PREPARED STATEMENT OF J. IRWIN MILLER

I am not an authority on taxes, but am instead a businessman with only partial and selective knowledge of the subject. I would, therefore, like to begin my comments with one sentence in Senator Proxmire's press release of July 7: "The tax reform debate has been characterized by the lack of hard facts and careful studies of the tax system."

Considering the magnitude and speed of change in our society, comprehensive tax reform is today long overdue, and in the future will be required at regular and more frequent intervals. My great concern, however, is that tax reform as conducted in the past, mainly piecemeal, will probably not provide the national improvements you are seeking. Before the effects of tax reform can be reasonably predictable, and the reform itself successful in the light of national goals, the Congress and the Administration must have at their disposal better facts than now seem available, and they must develop a new competence to understand in detail and in depth how our tax system works.

THE CAPABILITY REQUESTED FOR EFFECTIVE REFORM

Congress ought to avoid piecemeal reform. A case by case determination of what is a good or bad tax or exemption could well result in a situation no better than the present. Our nation is now so extraordinarily complex and changing so rapidly that no single tax nor any simple collection of taxes can be enacted which is both equitable to all taxpayers and harmoniously aligned with our national goals. For the foreseeable future this country, from the local to the federal level, will be compelled to have a *System of Taxes*, not one tax, and not a Collection of Taxes.

Taxes interact upon each other, and upon the nation's economy. A sales tax that is too high may reduce seriously your estimates of the take from corporate income taxes, and a tax which raises too high the risk of long-term investments may channel investment funds disproportionately into areas of short term payouts forcing cheap rather than durable additions to the nation's productive capacity, diminishing capital additions prudently required, and depriving the country of its technological future.

You need *an advanced and dependable means of asking "What if?"* about each combination or system of taxes you contemplate. The old methods of a simpler time, when the impact of taxes was less pervasive, will be dangerous to follow in the future. Our affairs are so complex and intertwined that serious and large scale errors are inevitable if decisions are made without knowing with reasonable accuracy the interaction effects of any given combination of taxes and the final results for the nation. We are beginning to develop new tools in the new science of mathematical modeling, which can reduce some of these risks. Congress and the Administration should take advantage of these tools now, and push their development to a point of consistent reliability.

The Congress must ultimately go a great deal further, and be able to consider the advantages of taxes vs. alternatives to taxes. It might decide, for example, to provide either federal grants or tax benefits to power companies in order to speed their pollution expenditures without raising power prices by the full amount of the new costs involved. On the other hand, it may, for automotive emissions, simply set what it considers to be reasonable dates and reasonable goals for compliance, and rely on strict enforcement rather than the carrot of federal funds. Since higher prices to consumers, at least for a considerable time, would be expected to result from some proposals, the Congress would need a means of asking "What if?" when comparing the ultimate effects of tax vs. non-tax alternatives.

In reading the studies of the committee I found excellent discussions of probable interaction effects within limited areas. But even here, it seems clear that inadequate facts were available and that almost no mechanisms existed for acceptance among responsible authorities. As for calculating interaction effects of different categories within the gross tax system, I saw no consideration of these in the studies. And yet *these interactions in fact exist, and they effect us all*, and they are of importance to the whole.

The implications of all this seem to me to be very profound. Beginning with the thread of tax reform, it becomes clear that one must first have a base of generally adequate and reliable facts. Then a systems-analysis capacity for the affairs of the whole nation becomes important, and a modeling capacity so that reliable answers to important questions can be obtained. Finally, there is surely implied a clearly articulated program of national priorities, and sophisticated national, local, and regional plans for achieving the priorities. Only when the priorities and the plans are in place will we be able to decide in a responsible manner whether a tax is a good tax or a bad tax, and whether a tax system is a good system or a bad system.

We do not possess such sophistication as this today, and it will come hard. But we are clearly capable of achieving it, and the nature and importance of the decisions which the Congress and the Administration will be making by the end of the century are such that we will wish we had made a serious start now.

THE SYSTEM TO BE REFORMED

Tax reform must constantly keep in mind that taxes are an integral part of our total government system.

First, there is a national mood today which says "Taxes are Bad" and that, the lower the taxes, the better off everyone is. I think this results from the frictions produced by a system grown long out of date, frictions which need to be removed systematically and comprehensively. It is, therefore, not a patch-work job that is now called for.

Taxes are not "bad", any more than the price we pay for anything we want and need is "bar". Taxes are the price each citizen pays for the essential services of government.

Paradoxically, we complain as much about deteriorating services as we do about high taxes. Our wants today are very great indeed. We want equal justice available to every citizen without regard to his wealth, race, or religion. We want continuously adequate transportation, steadily improving education for our children, a clean environment, an adequate defense, pleasant cities, superior health care, and the rest of the services we expect from government. We want these today, and we and our children will want them 28 years hence, when there will be from 75 to 100 million more of us added to the population.

We also want these services provided at higher standards of quality than we perceive today. We remind ourselves that we are the most affluent society that has ever lived, and we ask ourselves what is affluence for, except to provide the great public services at higher quality and to more people.

The nature of our expectations is such; the near-term growth of our population will be so great; and the time available for accomplishment is so short that large additional sums of money will clearly have to be raised and spent now and probably in different patterns of allocation, if the public sector of our lives is not to decline to a dangerous quality. The matter is urgent simply because it is always less expensive to keep up than to catch up.

What are we reluctant to face, and what the Congress must face is that all this, even performed with ideal efficiency, is going to cost more. In order to bring our public and private standards of living into balance, you gentlemen are going to have to raise taxes.

In the material sent me I did not find mention of the fact that the gross dollar expenses of all government will have to increase. I doubt whether tax reform can be discussed in realistic terms, unless the reality of increased taxes is discussed simultaneously.

Second, if taxes are the price for essential services, and, if the amount and cost of these services is expected to increase substantially, then, as a part of tax-reform, you must consider the expense side of the government's operations. There is a clear call in times of rapid change to dispense with all services and programs no longer needed (no matter how sensitive politically), to add new services for whose lack we are suffering, and to accomplish sophisticated and courageous plans for improving the efficiency and effectiveness of existing services. Taxpayers will have a right to expect the removal of duplication, elimination of the nonproductive, and the establishment of a new rational interface between federal agencies and between the federal government and state and local governments.

To an outsider, it has often appeared surprising that one group in government can consider programs and appropriations, a separate group handle taxes and revenue to support the expenditures, but that, all too often, no single responsible group couples the two together and faces up to the question: Is the program worth the additional taxes required? Does it give value received? As a former member of the Commission on Postal Reorganization, it was apparent to me that a major reason for growing postal deficits was that no person or committee had the clear responsibility to relate postal rates to postal expenses, and thus accept responsibility for the postal deficit.

AREAS FOR CURRENT FOCUS

But all this will not come soon enough to help today's Congress solve today's tax problems. Even with imperfect data, some beginning must be made, and it seems to me useful to consider such a beginning under three broad categories.

The first is equity or fairness or redistribution of wealth. The second is the nature and effectiveness of those incentives which are an inescapable characteristic of any system of taxes. And the third is the efficiency and ease of administration of the present system.

It is a curious thing that redistribution of wealth commands so much attention in a society broadly affluent beyond most of the dreams of history. I can only suggest an answer.

When scarcity and poverty were the rule, it was possible to say to a general population with some justice that it was more important to increase the size of the whole pie than to argue over the size of the slices of a pie that was inadequate, any way you sliced it. Once, however, the pie becomes big enough for all, the size of the slices becomes of overriding importance to the population—as is now the case with us.

I think it is also worth observing that a continuously equitable distribution will probably make the size of the pie grow faster. Inequity introduces frictions, cross-purposes, and a degree of national frustration which can only inhibit growth.

Nearly all authorities agree that, in the last twenty years, incomes in all segments have been rising proportionately. This has meant a widening of the dollar gap between the segments. While government spending has caused some mild redistribution, overall there has been no significant change in the distribution of net real income.

Our concerns in this area are, I think, rooted in a national principle which we have come to call Equality of Opportunity. Some nations do not make so big a thing of this as we do. Some nations profess to aim simply at Equality, which we reject. What then do we mean by Equality of Opportunity? At the risk of over-simplification, I should think we mean an equal chance at the starting line for each American baby. Some babies will, of course, fail, some succeed. Some will run further and faster than others. Some will be more fortunate in their choice of parents. And "success" is, of course, never to be measured in terms of dollars alone.

But we believe there should be no external handicaps at that mythical starting line, in so far as we can arrange it. No helpless baby should be permanently handicapped in respect to his Opportunity because of inadequate diet, or lack of health care, or the receipt of an education less than he has the capacity to absorb. These are some of the things we mean by Equality of Opportunity. They will cost more tax dollars than we now appropriate, and in this respect we enjoy talking about Equality of Opportunity more than we enjoy funding it.

Because this aspect of the American Dream costs money, it gives rise to another concern. And that is ability to pay taxes.

There can never be very precise measures here, but, if some categories of taxpayers are in fact taxed substantially more heavily in relation to their ability to pay than others, then you have seriously damaged the validity of the concept of Equality of Opportunity as it might apply to today's generation.

How should you go about determining relative abilities to pay among so diverse a population with such diverse sources of wealth and income? I cannot, of course, in one brief memorandum give a very useful answer, but I can at least suggest profitable lines of inquiry.

First, our progressive tax structure relates primarily to income, and, to its credit, is more progressive than that of most European nations. However, as a man becomes wealthier, a greater portion of his income is derived from his capital. This tends under our present tax structure to moderate the progressive nature of the present income tax.

Some light on the problem might be obtained by calculating for representative classes of citizens taxes paid on a calculated *combined net worth.* This could be composed of present tangible net worth plus a reasonable capitalized value for salaries, wages, and pension benefits. Since this calculation would show relative percentages of tax paid for individuals of differing combined net worth, it might begin to shed some light on the degree to which our present tax structure recognized ability to pay.

Second, in figuring ability to pay, it would be necessary, as our elementary economics text-books told us, to remember that the value to an individual of the first dollar he earns or owns is very much greater to him than the value of the thousandth, or hundred-thousandth. Some appropriate account would need to be taken of this, especially as it might affect taxes paid by the lowest income groups.

Finally, I suggest that account be taken of the method by which we tax real estate. While real estate, like other forms of wealth, is generally subject to a capital gains tax upon sale, it is also annually subject to the local property tax, which is levied on the total value of the real estate, both cost and unrealized gain. In this respect it differs from the method of taxing other forms of wealth.

This point is worth noting, because the first sizeable piece of tangible net worth which many Americans tend to own is a house and lot (or they will pay rent on real estate, including its property tax charge), and the other forms of

net worth which they later acquire, as they continue to prosper, are more likely to be those whose original cost and unrealized gains are not regularly taxed.

I mention these isolated and even fragmentary calculations because I suspect that, despite our intentions, our tax system may have become, not even proportional, but in a real sense regressive, especially when to the above there is added the regressive effect of sales taxes, social security, and probably the corporate income tax.

Finally it will be important for you to note that a system may also be regressive or progressive according to how the money is spent. Equity can be fostered by choices of national priorities. For example, the national degree of equality of opportunity is affected according to our decisions on defense spending vs. housing, or public transportation vs. highway construction, or education vs. agricultural subsidies. Maldistribution can result as much from who receives as who pays, and the Congress will have to take account of this.

These are comments only. They cannot be definitive, but they may serve to suggest lines of investigation in addition to those covered in the material which I received.

May I proceed now to my second category? It seems to me that too little attention is paid to the fact that, whether by design or not, our system of taxes is also and always will be *a system of incentives*. Each tax-payer, from the middle-income to the higher-income and certainly including the corporations, has a choice in the way he spends and invests his income and his capital, and his final tax bill is no small part of his considerations. Let me explain this with some examples.

In some cases taxes or tax-exemptions have been established to encourage the flow of funds in certain directions. For example, America has long taken pride in the fact that its citizens, more than most, feel a strong sense of responsibility for the quality of their nation and the correction of its ills. We feel that this voluntary acceptance of responsibility at all levels is one of the essentials of our greatness as a nation. Our tax laws have encouraged this, more than the laws of most other nations, by means of the charitable deduction. The result is that in no other nation do so many citizens and organizations contribute voluntarily as much time, money, and effort toward the improvement of society as do Americans. Our tax structure can either encourage or destroy this tradition. Abuses certainly ought to be identified and prevented, but, if we enact provisions to discourage people from giving, or if we decide that it is the exclusive business of government to decide what purposes are good to give to, and what are not, then citizens will gradually stop giving at all, will feel less and less personal responsibility for the welfare of their own community or their nation, and the alienation of the people from the state will proceed apace.

In other cases, similar incentives exist but were never contemplated by those who first wrote the taxes. For example, in many cities slum property commands almost as high rent as improved property. The slum landlord who spends the least possible on his property finds himself with a more lucrative investment than the landlord who thoroughly renovates similar property. The unplanned tax incentive can thus be to perpetuate slums, an incentive which we try to counter, not too successfully, with a collection of regulations, enforcement officials, and federal and local spending. The tax laws could be written to make it unprofitable to own and operate run-down real estate, and potentially profitable to own and operate improved properties. The same amount of tax might be collected either way, but, in the second instance, the economic incentive and the national interest would coincide, thus relieving much of the necessity for agencies, regulations, and enforcement officers.

It is possible to shift existing incentives and to direct cash flow into those areas most beneficial to the nation. For example, with corporate profit margins at the lowest percentage in over 30 years, with industrial productivity static and service productivity probably declining, we are concerned with our ability to compete with the most successful industrial nations. But, under a condition of minimum cash flow, little money is going to be invested except where immediate returns are in prospect. There is evidence to believe that American investment in long-range research and in capital programs to improve long-range productivity may be declining in comparison with our neighbors. Where should deductible expenses flow—into unlimited advertising of undifferentiated products, with admitted short-term payout, or into efforts to improve our technological lead over our world competitors? It is, for example, not impossible to continue programs like the Investment Tax Credit (or even more sharply effective ones) and at the same time raise the overall corporate rate by the estimated amount of the

credits. Those firms most determined to advance would thereby receive special incentive to do so, and the nation would not have lost tax revenue.

Or, we can create new incentives. A recent tax in the United Kingdom is worth studying. Each manufacturing firm is taxed a fixed amount per employee. The only way a firm may recapture this tax is to institute and carry out a government-approved apprentice training program, which it may do to the full amount of the tax it has paid. An observation of British industry (which suffers in comparison to ours in other respects) will confirm that there is a very great deal more training of young boys and girls in valuable industrial skills going on there than here—and without the necessity of massive government funding.

In the study material which I received from the committee, questions were raised as to whether many of the present programs actually did provide the incentives they were intended to provide, or provided them in a degree proportionate to the tax deduction, and whether they were not instead little more than tax "give-aways".

Speaking as a businessman, I believe that intended and unintended incentives do make a difference in the amount and direction of our spending plans, particularly now at a time of historically low profit margins when each business has more good projects to fund than it has cash flow to support. Making all tax incentives effective, and bringing them into line with national purposes is important to the nation's progress and would probably reduce significantly the cost and need for government regulation and enforcement bodies.

The need again is for the Congress to have always at its disposal the quantity and quality of facts, the modelling capability, and the systems analysis techniques adequate to make accurately informed judgments and decisions.

Concerned as most businessmen are about rising costs of government, I think most of us would support with enthusiasm the development and maintenance of a truly adequate body of facts and anlysis technique continuously available to the Congress.

Now briefly for the third comment. Compared to the first two it may be minor, though still not without importance.

Our tax system has become too rigid for effective administration in times of rapid change, and it has become too complicated for most of our citizens to understand.

May I discuss the point of rigidity first. Economic and monetary conditions change so rapidly now that in many instances reasonably swift response by government is called for. We have the capacity of prompt response in respect to monetary policy, but in fiscal matters no change can take place without thorough Congressional review. Some flexibility within set ranges might advantageously be given the Executive to permit appropriate use of fiscal as well as monetary tools in responding to changing situations and needs.

In respect to complexity, our system is hard to understand, and it is expensive to administer and enforce. In fact, because of its complex and patchwork nature, many tax returns can never be checked and one must wonder how high or how low the tax yield really is.

A serious attempt ought to be made to reduce the complexities of tax returns, to structure them in a manner which would make both collection and enforcement less expensive and more certain. I am certain that the expert knowledge and experience exists to accomplish this, both inside and outside the Internal Revenue Service. And I am sure that any such effort would be truly rewarding.

It would reduce government costs, taxpayer costs, and it could improve tax yields. If, in attacking this, a beginning could be made at consolidating the payment of local, state, and federal taxes, there would be additional savings and additional cause for taxpayer gratitudes.

In conclusion, I appreciate the invitation to testify and express again the hope that the Congress will take a serious and comprehensive view of tax reform, not a piecemeal one, and will consider, as it undertakes its work, what the Congress of the year 2000 will wish this committee had been doing in 1972.

Chairman PROXMIRE. Thank you very much, Mr. Miller.

Mr. Harrington, please proceed.

STATEMENT OF MICHAEL HARRINGTON, AUTHOR

Mr. HARRINGTON. First of all, I am particularly happy to be here because I think the research and the hearings of this committee have

been providing some of the most important data to social policymakers in the country in recent years.

Before I begin, I would like to correct one error in the prepared statement that I presented to the committee. I misread the Pechman-Okner estimate of tax subsidies. I have a figure of $166 billion. That accurate figure is $77 billion.

What I would like to do this morning is not to talk about the specifics of the tax system, because I make no claim to expertise in that area, but rather to talk about the broad underlying philosophy of tax reform. The main point I want to stress is this: The issue is not whether the Government is going to redistribute wealth. The Government is already redistributing wealth. The question is not whether there is going to be redistribution, but how.

In that context, I would suggest that President Nixon is a redistributionist and that he has presided over the redistribution of wealth. One therefore should not counterpose the present reality to redistribution. We should understand we are talking about how the Government, which in fact is already redistributing wealth, will do it, how it should do it.

I speak as a democratic socialist, but what I say in no way requires one to be a socialist to agree with me. I think it is not only compatible with the general liberal philosophy in the United States; I think it is even basic to democratic values themselves. Let me try to spell out that proposition about redistribution.

The underlying assumption in the best testimony before this committee and in the excellent staff study on subsidies, and in what Senator Harris and Messrs. Stern, Pechman, Okner, and Surrey said is that the pretax income is market-determined. You determine the distributor effect of the tax system by taking pretax income as a given and then trying to find out the effective rate of taxation, subtracting from that the subsidies and the transfer payments, computing the value of the services received by the various groups. You find from those figures what the effect and distribution of the tax system is.

Given that way of looking at the reality, the maldistribution of income in the private sector is of no concern to Government policymakers. For example, in some of the testimony on capital gains tax, that maldistribution is seen as economically functional in that theoretically, it provides incentives for the creation of wealth which benefits the entire society. From the general assumption, that the Government only affects income distribution through the tax system, and that pretax income is independently established comes the corollary or the policy conclusion that the tax system really should be very careful in how it deals with this hen that is laying the golden eggs.

I would criticize those assumptions. I would criticize them on the grounds that they ignore a basic change in economic reality in this society. The change is that the Government today is perhaps the most important single determiner of pretax income, of its quantity and its allocation. This is obviously true since the Employment Act of 1946 charged the Government with the responsibility of managing the economy to provide the effective demand that would yield full employment, although it has rarely done so. It is obvious, for example, that in the 1960's, the drop in unemployment and the rise in the strength of the economy in general, was in large measure powered by the tax

cuts of the Kennedy and Johnson administrations. It is obvious, given Mr. Nixon's old economic policy, that that has had a profound effect on the total of unemployment. It has increased unemployment and problems like poverty and the like. Therefore, the Government determines the general level and is a decisive force in determining the general level of production in society. The Government also profoundly influences how our production is allocated.

For example, the fact that President Kennedy was, I think because of political factors, forced to an investment credit and depreciation meant that the Government decision powered a capital goods boom rather than a consumption boom. It meant that the economy became unbalanced; and it meant that those enterprises in the sector which the Government was encouraging to produce got a particular benefit and advantage. That is certainly true of President Nixon's job development credit, which proposes Government incentive to modernize and create new capacity at a time when you have excess capacity of 25 percent.

Therefore in terms of Government policy, it affects the allocation of resources and it seems to me, in the last 12 or so years, it has consistently done so by redistributing wealth from the poor and the working people to the rich, by providing the main subsidies to the top of the economic pile rather than to the bottom.

Finally, as the committee has pointed out so well, the Internal Revenue Code embodies a distinct system of subsidies equal to at least a fourth of the Federal budget and in general channels the tax burden from rich people to poor people to working people. This, I think, is also very true of the administration's tax policies since August 15, 1971.

Therefore, the question is not whether the Government is going to influence the distribution of wealth, it is how it is going to do so. And I hope we do not in this society get into a pseudodebate over the question of whether the Government has these redistribution powers when the real debate should be over how such influence is used.

Therefore, in terms of the philosophy of tax reform, it seems to me that under conditions where the Government induces and broadly allocates much of the wealth of the society prior to the collection of taxes, that the tax system has a new and special responsibility. It is not a radical responsibility but a responsibility in equity—to orient toward changing that flow from poor and working people to rich. Let me be specific now in just a couple of the areas that I touch upon in my paper.

First of all, I think that in terms of full employment policy, the tax system should not be the chosen instrument. It is an instrument, but it should not be taken as the decisive instrument. I believe what we need in the society is more planned social expenditure and less tax expenditure. And I say that even when the tax expenditure might go to the right people as it does not now. I think the priority should be toward the new cities and towns that we have to build—the housing that we have to build and toward creating a health system that would be equal to the resources of this Nation. That requires planned social investment, not more tax expenditure. I think it is an unfortunate trend that several witnesses before the committee have identified, that tax expenditures have been increasing in recent years, rather than going down.

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Moreover, I think there are reasons why the tax system tends to be biased toward the rich. I think it is biased toward the rich, among other things, because the rich have a huge and tax deductible stake in hiring the lawyers and accountants to see to it that it favors them. I know in my own experience in and around the American labor movement that it is a feeling of a good many people in the labor movement that the toughest battle to fight is on tax policy. Because while you are closing up a loophole over here, a small army of geniuses is down the hallway putting a loophole in over there. I think that is another reason why the chosen instrument of full employment policy should not be the tax system.

But obviously the tax system has virtues in the fight for full employment, not the least of which is it can very rapidly affect aggregate demand in the economy. And where the tax system is utilized for that extremely important and basic purpose of government, I think that it has to, again, be oriented toward the people at the bottom, consciously. I say this not simply, as I think the staff study of the committee implies, not simply for ethical reasons. I am certainly ethically concerned that Government be following the priorities of equity and democratic value, but also, I think, on economic grounds, that by stimulating the consumption of great masses of people, you are going to have a better economic effect from the standpoint of full employment policy than by any kind of tax expenditure.

Finally, in saying that we should do away with all of the subsidies, not only the Internal Revenue Code, I am not thereby at all suggesting that we should get out of the field of concern which these subsidies badly represent. I think the former Secretary of the Treasury, John Connally, was much too pessimistic about the capitalist system when he said that if you remove some of the subsidies, the Dow average will plummet down to 500. I don't think this system is dependent on Government intervention and expenditure in the housing field primarily for the rich while there are slums for the poor. I think there are other ways than tax expenditures for the rich to deal with the problem of housing. In advocating that we do away with these tax expenditures so skewed to the housing of the rich. I don't advocate that we, therefore, get out of the housing field. On the contrary, I propose that we spend the money we would thus save in really dealing democratically with the area of housing.

In conclusion, then, what I am saying is that we have a new economic setting which policymakers have to take into account. The issue is not whether or not there is going to be a redistribution of wealth in this country by the Government; there already is: it is how. I am proposing that that redistribution be consciously democratic.

Thank you.

(The prepared statement of Mr. Harrington follows:)

PREPARED STATEMENT OF MICHAEL HARRINGTON

The American tax system is increasingly an instrument for the redistribution of wealth from the poor and the working people to the rich. Its basic priorities must therefore be reversed. In the immediate future that could, and should, mean that $77 billion now allocated by the Government to the affluent minority will be put to the service of the majority.

The Joint Economic Committee and Chairman Proxmire deserve enormous credit for having undertaken an investigation of some of the inequities in the tax system. I cannot too much praise the hearings which have been held and

the papers and the staff study which have been published. For those of us, like myself, who have no pretense to special expertise in tax matters but who are deeply concerned with the direction of social policy, the Committee has provided indispensable data. I stress my own personal debt of gratitude since I intend to take issue with some of the basic assumptions of the Committee staff and witnesses. I therefore want to acknowledge that I am able to do so in considerable measure because of research undertaken by advocates of the very theories I will criticize.

To anticipate my conclusions, I believe that Federal fiscal policy should be a decisive means for promoting, not simply the quantative levels of full employment, but the quality and shape of the national product as well. The tax system is not suited to be the primary means for promoting those ends but it has an extremely important role to play in the achievement of full, meaningful employment which could be roughly defined as exactly opposite to what is being done today). One crucial way of asserting social priorities in the Internal Revenue Code is to repeal all the subsidy provisions it now contains. These mainly favor the wealthy and, as Joseph Pechman and Benjamin Okner pointed out to the Committee, their abolition would free $77 billion of Government income which could then be devoted to the common good rather than, as now, to special interests.[1] I also think we should consider doing away with all other taxes, Federal state and local, and to rely upon a really progressive Federal income tax as the sole source of public funds for all purposes.

I will detail some of those ideas shortly. But first, some general thoughts which challenge the established—liberal and conservative—wisdom.

We are in a new period in which there is no question of *whether* the Government is going to determine, in broad measure, the distribution of wealth, but only as to *how* it is going to do so. Therefore it is wrong to counterpose "radical" redistributionists on the Left to those who humbly submit to the free market distribution of income on the Center and Right. President Nixon is as radical a wealth redistributor as I am (and much more of a radical than that reasonable moderate, George McGovern). Mr. Nixon and I do not disagree on principle. He favors policies which redistribute wealth to the rich whereas I think that the government should channel resources to that majority whose basic, and crying, needs are far from satisfied.

To make my point perfectly clear, let me turn for a moment to fundamentals.

In the current orthodoxy, pre-tax income is taken as a given, established by the play of a free market. To determine the distributive effect of the tax system, you then compute the effective rate for various income classes, subtract subsidies and transfer payments which the groups receive, and figure out the value of the public services which accrue to each category. Given this methodology, one discovers that the American tax system is moderately progressive and requires, at most, only an end to some of the most discriminatory features of the Revenue Code. The guiding assumption is that the economic substratum, the free market, is basically sound and, though it contains obvious inequities in income, is the best mechanism for guaranteeing that economic growth which will benefit all citizens.

Thus, that invaluable Populist, Senator Fred Harris, said, in the course of commenting on monopoly prices to the Committee, "Now, I think it is highly important that this subsidy be eliminated by moving forward to the free enterprise system. Some people say we want to move back to the free enterprise system. I don't think that it is the right way to phrase the problem. I want to move forward to the free enterprise system and I think that bringing competition to the market is a better planning mechanism than anything else we can advise."[2] And the Committee's own staff study argued that the issue is one of correcting "defects" in the market system which is seen as an efficient, and just, distributor of wealth.[3]

I think that the orthodox assumptions underlying these statements ignore a basic structural change in American society—and in the duties of the American government. In saying this I speak, of course, as a democratic socialist. But it is important to emphasize that on this particular count it is not in the least necessary to agree with my political philosophy in order to accept my specific analysis. My argument, I believe, makes sense within a liberal, as well as a socialist, framework.

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[1] Hearings, Subcommittee on Priorities in Government of the Joint Economic Committee, January 13, 14, and 17, 1972, p. 61.

[2] Hearings, op. cit. supra, p. 126.

[3] "The Economics of Federal Subsidy Programs," A Staff Study Prepared for the Joint Economic Committee, January 11, 1972, p. 45.

Pre-tax income is not a given. It is a social, and increasingly a governmental, product. Ever since the Employment Act of 1946, Washington has been legally charged with the maintenance of a full employment economy. In 1961, with the triumph of the "New Economics" under President Kennedy, the Employment Act, which had been honored in the breach under President Eisenhower at an unconscionable cost in chronic unemployment, became the effective law of the land. This remained true under President Johnson, who successfully built on the foundations laid by Kennedy, and even under President Nixon. If Mr. Nixon's initial game plan—budget balancing and tight money in an effort to trade off some unemployment in return for price stability—was a disaster, it nevetheless demonstrated that the Federal Government is the most decisive single factor in the economy.

This is not simply a quantitative fact according to which Federal outlays are a crucial aggregate. It also relates to the very character of the national product. The decision made by President Kennedy to stimulate the economy by investment incentives rather than, say, through a massive middle- and low-cost housing program, had a profound—and negative—impact upon the way in which our resources were allocated. Mr. Kennedy probably acted as he did because of his precarious political position in the Congress in 1961 and 1962. In following the same pattern with his mislabeled Job Development Credit, President Nixon is, I suspect, acting out of a principled, conservative commitment to trickle-down economics. That explains his massive Federal subsidy for modernization at a time when 25% of industrial capacity is idle, a policy which might be accurately called a Job De-development Credit.

Finally the government's intervention also bears massively upon how the Federally generated wealth is distributed. As Leon Keyserling analyzed the percentage gain of various income groups through the 1964 personal tax cut, people with incomes of $3,000 benefited at a rate of 2.0%, those with $5,000, 1.6%, $7,500 at 2.1%, $10,000 at 2.3%, $25,000 at 3.8%, $50,000 at 6.2%, $100,000 at 8.3%, and $200,000 at 16.0%.[4] And this same pattern of governmentally determined maldistribution is even more pronounced in the various policies stemming from Mr. Nixon's August 15, 1971 change of game plans.

In short, the pre-tax income of the United States is not a market-determined given (it never was, but I will leave that historical point aside). Its quantity and distribution and the very character of the Gross National Product are increasingly the result of government intervention. Public policy must therefore change to keep pace with economic reality.

In 1967, the Council of Economic Advisors provided one of the few official intimations of this situation that I have encountered. In the new setting of governmentally maintained stability, the Council said, "profit margins not only should be lower in the boom phase . . . but should be reduced on the average because *operations in such an environment carry less risk*."[5] I would generalize that insight. Since economic growth more and more depends, both quantitatively and qualitatively, upon the democratic power of the people, i.e. upon the intervention of "their" government (or, more precisely, of the government that should, by rights, be theirs), Federal policy must be more and more directed to insuring a social distribution of the socially generated national product. The alternative to such an approach is not humble submission to the dictates of the free market. It is the radical redistribution of those conservatives who want to put the economic power of all the people in the service of the wealthy few.

Given this framework, I can now proceed to my specific suggestions.

Since President Nixon abandoned his Old Economic Policy in 1971 and accepted the principle of the "full employment budget" ("By spending as if we were *at* full employment, we will help to *bring about* full employment"), there has been an apparent consensus in this area.[6] And yet, there is still a fundamental difference between the democratic Left and the sophisticated Right on this issue. Republicans are somewhat shamefaced about deficits and wary of public outlays (which they regard, quite wrongly, as "socialistic") and therefore instinctively seek to unbalance the budget by tax cuts, investment credits, accelerated depreciation and the like. As Seymour Harris remarked of President Eisenhower's tax cut, "An administration wedded to anti-spending policies may

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[4] "Taxation of Whom and For What," by Leon Keyserling, Conference on Economic Development, Washington, D.C., 1969, p. 21.

[5] Report of the Council of Economic Advisors, 1967, Washington, D.C., 1967, p. 133. Emphasis added.

[6] Richard M. Nixon, January 22, 1971, speech to a Joint Session of the Congress, in "A New Road for America: Richard M. Nixon's Major Policy Statements, March 1970–October, 1971." Doubleday, Garden City, 1972, p. 8.

accept a tax cut even though this is contrary to its deficit theories; but never a rise of public spending."[7] That applies roughly to Mr. Nixon at this very moment.

Moreover, the individual and the corporate rich have invested millions of—tax deductible—dollars into drilling, and sometimes dynamiting, loopholes into the Internal Revenue Code. The great mass of people do not employ a small army of accountants and lawyers to look after their interest in the course of the legislative process. Therefore there is an institutional bias in the tax system in favor of deficits achieved by further maldistributing the wealth of the nation. It is correctible, but only through the most concerted and effective political action. For that reason among others I think it infinitely preferable that full employment policy be powered by planned public investments rather than by tax cuts.

But it is obvious that the tax system, which is perhaps the fastest instrumentality for affecting aggregate demand, cannot be shunted aside in the fight for full employment. Therefore when it is used for this purpose, tax cuts (or increases) must be designed to favor those at the bottom of the economic pile (and be accompanied by a "negative" tax payment to those people who are out of the system altogether). This is an obvious application of the principle which is almost as universally ignored as it is universally accepted in this country: that taxation should be related to ability to pay. It is also in keeping with the premises of neo-classic economics since it is clear that the marginal utility of a dollar is much greater for a starving man than for a rich man.

This is not to say, as the Committee's staff study implies, that a redistributionist approach oriented to the majority rather than, as now, toward the minority can only be justified on extra-economic, "ethical" grounds.[8] When that is said in the United States it usually means that the "ethical" policy is tender-minded, unproductive and fit for Sundays but not for working days. In fact there is a greater *economic* stimulus which comes from social investment in mass consumption since the majority desperately need to utilize 100% of the sum spent upon while a corporation might well decide not to take advantage of the Job Development Credit. And secondly, by concentrating on the needs of the poor and working people the Government can help create a much better socially balanced national product that we have now. Indeed, I suspect one of the causes of the turbulence of the past half of the Sixties was that Washington subsidized, not only the wrong people, but consequently the wrong production as well.

The need to abolish all tax subsidies follows from this analysis, since they are a prime means of skewing the nation's priorities. The Committee's estimate of the cost of those subsidies—$38 billion—is, as Senator Proxmire remarked, based upon a "relatively conservative definition."[9] It computes the loss from the capital against provisions at $7 billion whereas the Pechman-Okner estimate, derived from more recent data, puts that windfall at $14 billion.[10] It does not take into account the imputed rent of owner-occupied dwellings although it is noted that the cost of this provision may be $4 billion.[11] And it does not give any estimate for the tax cost of the Defense Budget (which includes other massive subsidies in the form of below-market rates for the use of the more than $13 billion in plant equipment owned by the Department of Defense, non-competitive prices, cost over-runs, and the other forms of semi-nationalized largesse which are showered upon private profiteers in this area). The Pechman-Okner estimate of $166 billion in subsidies through the various deviations from the economic definition of income in the Internal Revenue Code is thus quite plausible.[12] That sum describes a Federal budget for the rich almost equal to the official Federal budget for the entire nation.

I will not comment at any length on the specifics of this outrage since the testimony of Messrs. Philip Stern, Joseph Pechman, Benjamin Okner and Stanley

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[7] "The Economics of the Political Parties," by Seymour E. Harris, Macmillan, New York, 1962, p. xxliii.

[8] Thus the staff study remarks "Even if the distribution of income is considered right to begin with—and many would cite ethical considerations to the contrary . . ." I will cite economic and ethical considerations. Staff Study, op. cit., supra, p. 45.

[9] Hearings, op. cit., supra, p. 2: Staff Study, op. cit., supra, p. 4.

[10] Hearings, op. cit., supra, p. 98.

[11] Staff Study, op. cit., supra, p. 152, n. 2.

[12] Hearings, op. cit., supra, p. 61.

Surrey was so expert and convincing. However there are a few points which I would amplify.

Some of the witnesses shied away from the idea of treating capital gains as ordinary income. I do not. One of the many reasons for my attitude is that the stock market plays a declining role in the process of actually raising capital, most of which comes from retained earnings, borrowings, depreciation reserves and, according to Murray Weidenbaum's testimony, Government-subsidized credit.[13] Indeed, much of what takes place on Wall Street has all the redeeming social importance of a crap game. When, for instance, money was quite tight in 1969, the Wall Street Journal reported that the industry was concerned because investors were actually coming to the stock market for money. It quoted a partner in Solomon Brothers and Hutlzer: "Every time you add $1 billion to the volume through new stock openings, you take out $1 billion that could be used to push up stocks already on the market." [14] It is ridiculous to suggest that it is *economically* functional for the nation to subsidize such a process.

Secondly it should be emphasized that the abolition of a subsidy does not mean that the Government should be unconcerned and inactive in the area in which it applies. It does mean that tax subsidies are not the best way to proceed and/or that the tax subsidies are channeling funds to the wrong people, i.e. to the rich rather than the poor. Take housing as a case in point. The Committee staff found tax expenditures of $2.6 billion through the provision for the deductability of interest on owner-occupied homes, and $2.8 billion through the deductability of property taxes. It did not take into account, as I noted earlier, the imputed rent of owner-occupied housing, which could account for another $4 billion in subsidy. These monies go exclusively to home owners, i.e. they exclude the overwhelming majority of the poor and a good part of the working people. And they are, as witnesses before the Committee have conclusively demonstrated, given out in inverse ratio to need so that the rich got the most and the low income home owner the least.

Therefore the point of abolishing these subsidies is not to get the Federal Government out of the housing field, but only to put an end to what the late Charles Abrams called "socialism for the rich, free enterprise for the poor." Indeed, I believe that Washington should commit itself to a massive housing program with an initial commitment to building ten new cities of one million people each and ten new towns of one hundred thousand people (this was the proposal of the National Committee on Urban Growth Policy and it was endorsed by, among others, Vice President Spiro Agnew). One major source of funds for such an effort would be the more than $10 billion ($8.425 billion in tax subsidies, credit subsidies and cash outlays, and $4 billion in tax revenues from imputed rent which the Staff Study did not include) a year which could then be put to social use.

In this regard I find it ironic that I am somewhat more optimistic about capitalism than the former Secretary of the Treasury, John Connally. Mr. Connally, a most enthusiastic free entrepreneuer, has made the ultra-Leftist argument that if these various, and intolerable, subsidies were removed, the Dow average would plumet down to 500. As a socialist who thoroughly believes that this is indeed a contradictory and crisis-prone system, I cannot agree with Mr. Connally that it is so utterly, even pathetically, dependent upon such Federal handouts. American business could prosper if there were a gigantic housing market which included the poor and the working people. It does not require—though it has an inherent tendency to prefer—an anti-social allocation of resources in this sector brought about primarily by the intervention of the Government.

Thirdly, I believe that we should consider ending all taxes except the Federal income tax (with the reforms I have suggested).

It is clear that state taxes on consumption are regressive and so are local property taxes (particularly when one adds in the impact they have upon renters). It is also clear that various Federal taxes other than the income tax—social security taxes, for instance—are often regressive. Therefore on grounds of progressivity—and of efficiency since Internal Revenue usually gets high marks in that area—there is a very strong *prima facia* case for making the Federal government the sole collection agency for all public funds in the United States. A formula could be devised according to which a fixed—or under some circumstances, a rising—percentage of this revenue would be returned to local government.

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[13] Hearings, op. cit., supra, p. 150.
[14] Wall Street Journal, "New Offerings . . .", February 6, 1969.

I think this question is quite involved which is why I make this proposal tentatively, as a call for study rather than as a program for action. For instance, putting an end to the Balkanization of local government is an urgent necessity in America. We need metropolitan government and regional government and state and city lines are often economically irrelevant to the fundamental tasks before the people. I would therefore want to tie such an ambitious revenue sharing scheme into a series of incentives which would put a premium on metropolitan and regional innovation. I would also like to see such a reform as part of a commitment to a genuine national guaranteed annual income (and a guaranteed right to work). But my main point is, I think, obvious enough: that it should be a goal of public policy to put an end to all of the regressive tax systems in America.

In conclusion, let me return to my opening theme. In the old classical theory the justification of the maldistribution of wealth was that, although ethically unfair in the abstract, it provided incentives to talented individuals who then increased the national wealth in such a way as to benefit all citizens. That was never true, but I will not go into my reasons for thinking so here since it is not relevant to this particular analysis. Today, whatever the case was in the past, the source of wealth is increasingly not individual talent but man socialized by his technology and now, even in America, man socialized through his political institutions. In the process, government has become the most important single detriment of the distribution of wealth, before taxes as well as after.

Under these circumstances one can incorporate the old, elitist priorities into the increasingly socialized system. That is what President Nixon has done with his tax policies, which have enormously favored the corporations, and his wage and price controls. In that approach, democratic government becomes the instrumentality of minority interests more even than in the days when legislatures and legislators were bought and sold in this country. It is this philosophy which, for instance, led the Wall Street Journal to ask the Price Commission to allow the companies to better their position vis a vis the workers.[15]

On the other hand, we could adjust our political institutions to make them adequate to the new economic reality. If that were done, our basic philosophy of tax reform would not be redistributionism as against the free market, but a democratic and social distribution of the wealth induced by governmental action as against our present system of undemocratically and anti-socially distributing that wealth. The tax system has been, and is, an agency of anti-social priorities. It should be turned upside down.

Chairman PROXMIRE. Thank you very much, Mr. Harrington.

You gentlemen have presented most helpful and provocative oral statements and prepared statements.

You argue, Mr. Miller, in the first place that we ought to know a lot more about what we are doing in this tax area. We ought to recognize that we are dealing with a system of taxes we ought to have far more factual information available to us, we ought to have better staff, we ought to have models so we can see what happens when we change the tax system and we certainly ought to think in terms of priorities and tradeoffs. You argue that this is a system of incentives that should not be ignored and you have a very appealing, and I think persuasive argument that if we pay no attention to the effect on charitable deductions, it could have an adverse effect in many ways.

You make the interesting argument that contradicts what the people who have been making political progress in the last few months have been arguing, both Republicans and Democrats, who contend that the tax burden is too heavy. You say we are going to have to raise more taxes and you seem to say that this is in addition to any tax reform, that we are going to have to pay more taxes and should pay more taxes.

Now, how high do you go? You cite yourself as one who should pay more taxes—not personally, necessarily, but in a group, a group of people with very high incomes. As I understand it, the present effective tax rate goes up to 70 percent. It was 86 percent, it was reduced to 70

[15] "The Key to Business Confidence", the Wall Street Journal, February 9, 1972.

percent. But that 70 percent tax rate is not an actual effective rate in many cases, because of the loopholes in the tax law.

So what we have been talking about is raising more money by plugging loopholes, but you apparently would go farther than that, beyond that, and you say, you have to raise more revenues and the implication, at least, is that you may have to think about raising that 70 percent. Is that wrong or right?

Mr. MILLER. I would like to divide that up into the gross lump sum you have to raise and how you raise it, because we can't really talk about one tax at a time.

I think we all share the feeling that in an extraordinarily affluent society, the great public services are deteriorating. My kids attended our local public schools. They had 50 percent more or even twice as many children in the classroom as when I went to those same grade schools. In many cases, the teacher has a hard time doing anything but keep order. The quality of education under those conditions can only deteriorate.

Public transportation was better 30 years ago; the quality of air and water was better. The quality of health care advanced at that time, except for hospitals, was better. All these services, even the great universities, are going broke.

Now, I have a feeling that to restore these, we may be living higher on the hog in our private life than we should and that we are probably impoverished in our public life. As a Nation, it is my impression that we do not tax ourselves as heavily as the others of the five major industrial nations. I notice in one of your papers, there was the expression given, with which I agree, that we have the capacity to raise more taxes. However, due to the inequities of the system, every single category of taxpayer, including the wealthy, now feels disgruntled. And this is because of a tax system that has not been changed or altered as rapidly as times call for.

That is a general answer. I think that more taxes will have to be raised from the wealthiest segment of the Nation. As to what that rate will be, I do not know, because as I said originally, ours is a tax system. It is the system you have to look at and the interactions and the effects. But I think we will all have to pay more taxes.

Chairman PROXMIRE. We will all have to pay more taxes?

Mr. MILLER. I would exclude those approaching the poverty level.

Chairman PROXMIRE. But all incomes significantly above the poverty level?

Mr. MILLER. That is right, the middle income and above is going to have to pay more taxes.

Chairman PROXMIRE. That is interesting, because people are complaining, not just about the Federal income tax, which has been reduced, they are complaining about property taxes, all other kinds of taxes.

Mr. Harrington, you have an approach—perhaps we can put these two differing approaches together to some extent—that I think is fascinating and has intrigued a lot of people over time. You suggest that we simply concentrate on the Federal income tax. You didn't present that in your summary, but that is one of the fundamental thrusts of your prepared statement—we should forget about the cor-

porate income tax, sales tax, value-added tax, what not, and if we have a comprehensive and effective and fair and progressive Federal income tax, that should do the job.

Mr. HARRINGTON. Yes.

Chairman PROXMIRE. My concern about that is, No. 1, what do you do about State and local governments? Would you simply have to have revenue sharing? Is that the answer?

Mr. HARRINGTON. I think you have to. As I said in the prepared statement, Senator, I think this is an extremely complicated proposal. I am putting up the principle mainly because I think this gets a progressive source of funds as against regressive sources of funds, such as consumption taxes. Obviously, you would have to deal in a very complex way through revenue sharing with State and local governments.

Chairman PROXMIRE. If you deal with revenue sharing, you may start off with the notion that the Federal Government, although it raises the money, won't have dominance and control. But isn't it logical to assume that with the Federal Government raising all the money, they are going to step in and to some extent be watching that money, seeing where it goes, exercising control, that it might make our Federal system deteriorate to some extent? Don't you feel the independence of State and local governments might be lost?

Mr. HARRINGTON. I certainly think there would be that tendency and there would be a possibility that it would go too far. I think there is a danger to which there is no simple solution.

However, I would add to that that I think right now one of the great problems we have in this country is a proliferation of useless local jurisdictions. I think the Committee on Economic Development estimated some years ago that there were 80,000 of them. Some of them were not even viable.

Therefore, I think a system of modernization of Government, including much more metropolitan and regional government, might be forwarded by some such revenue sharing approach.

Chairman PROXMIRE. How about the idea that taxes can be used effectively and wisely in the eyes of a good many people to reduce consumption or to require people to pay for the services that they are getting? No. 1, you would imply, at least, that you would abolish any tax on liquor, on cigarettes, on gasoline so that people using the highways would be encouraged to use the highways even more than they do now, which I think is too much, and in many other areas where we have a system that does seem to be responsive, at least to some easily understandable purposes, and seems to be generally agreed.

Mr. HARRINGTON. Except there it gets back, I think, to something you were talking to Mr. Miller about. I think, for example, in the case of the user tax on highways, it does not begin to pay for the social cost of the automobile. One of the problems with our present tax system is it has an appearance of rationality. It has official tax rates which are not at all effective tax rates.

Chairman PROXMIRE. I certainly agree with that, but what you would do by abolishing the gasoline tax and the excise tax on automobiles and so forth is to aggravate that even more; would you not?

Mr. HARRINGTON. No; because I think there are other ways of Government policy to deal with transportation.

Chairman PROXMIRE. By regulation?

Mr. HARRINGTON. I would like to see us have a national transportation policy and make some basic decisions about mass transportation versus the private automobile.

Chairman PROXMIRE. I think the tax system can be a very helpful way of regulation. Let me give you an example of a tax we don't have.

West Germany has put into effect a system of effluent taxes, a tax on the discharge of effluent. The Ruhr River, the most industrialized in the world—it has coal, chemicals, everything you can think of—is one of the cleanest bodies of water. You can drink the water, swim in it. For years, they have had this system of effluent tax. It is a clear economic advantage to an industry, because the industry has the freedom to reduce pollution in their own way. And there is a payoff. They can increase their profits by reducing the amount of pollution they put in.

Your proposal would not permit that kind of tax, I take it, because you concentrate entirely on income tax.

Mr. HARRINGTON. Two things. One, I don't have the reference at hand, but there has been a recent report that indicates that the Ruhr system is not working quite that well.

Chairman PROXMIRE. Last year, I had a lot of opposition to this. Now the conservationists are all for it. We are getting a big head of steam behind it.

Mr. HARRINGTON. But the other gets to the whole problem of corporation, which is where is the tax going to fall? Who is going to pay for it?

Chairman PROXMIRE. The people who consume the product that pollutes pay for it.

Mr. HARRINGTON. I understand there are some disadvantages to my suggestion, but the enormous advantage is in terms of progressivity; it gets to——

Chairman PROXMIRE. No question about that. It is something we certainly ought to think about. I am just concerned about whether or not this is politically feasible.

You assert in your prepared statement, Mr. Miller, that an equitable distribution of income will probably make the size of the pie, the overall gross income, economic production, and so forth, grow faster. That contradicts the conventional wisdom of the so-called establishment, at least. They seem to, most of the people who have testified here, industrialists and others, say the effort to redistribute income would discourage the exercise of individual initiative and prompt businessmen to avoid even reasonable risks. One of the reasons Senator McGovern is having so much difficulty with the stock market and the reaction from Wall Street is that he believes in the redistribution of income and he has proposed a rather dramatic program to do that. The reaction, I take it, of our business community is that if you do that, at least his way, it is going to have an adverse effect on our whole economy. Do you disagree with that view?

Mr. MILLER. I see no incompatibility between reasonably effective incentives and equitable bearing of the tax burden. If the converse of that argument is that you have to have an unfair tax burden in order to make economic progress, that would be hard to swallow. So I would assume one of the things we are all concerned about is the national attitude toward the country, and to the degree to which

people feel that they are being governed fairly intelligently and wisely, I would assume that we are going to have a healthier society.

Chairman PROXMIRE. Mr. Miller, my trouble with you is that I just can't possibly disagree with your generalizations and your conclusions. They are very appealing. But when you get specific, does this mean that you would abolish the oil depletion allowance—which I would do—does it mean you would abolish the investment credit—which I would not do and you would not? Give me some specific examples of how to do this.

Mr. MILLER. Let's take one, the investment tax credit. We do not live in an isolated world to ourselves. We live and compete in the whole world. Whatever standard of living we in America have is, in effect, going to be as much determined by other nations as it is by ourselves. They will support our old population at a higher standard of living if they think American goods and services are worth it. If they think they are not, then our standard of living will decline and we will be trading $25,000 Chevrolets and $10,000 television sets and think we have a lot of money, but we still will be impoverished.

That, therefore, brings me to the investment tax credit. There is a way of treating these incentives which involve no giveaway. For example, you first determine what you want to take from the corporations. You then determine if you also want the investment tax credit, how much of that credit will be used by firms, and you raise the total rates until you recover that.

Chairman PROXMIRE. I see.

Mr. MILLER. That means that those firms who are aggressively engaging in advancing technology, in reducing costs and improving productivity through capital expenditures are encouraged. By the way, there is a feeling that the only way you improve productivity is to get everybody to work harder. That is not really the case. We are going to improve productivity by our intelligence in good part, which means by taking costs out.

If you do that, then those industries who are more static and less innovative will pay higher taxes, but those industries who have really something to contribute, both in technology and higher productivity and lower costs, have a chance to do so and the Federal Government still receives the same amount of taxes.

Chairman PROXMIRE. My time is up. Before I yield to Senator Javits, I want to say that that is a fascinating response and a very powerful one. What you would do is, you would apply the loss from the investment tax credit to a higher corporate tax rate. And you would achieve the goal you want of greater automation and greater efficiency and so forth, but you don't lose the revenues.

Mr. MILLER. Yes, may I add something?

Let's take Japan. Japan is a formidable world competitor. Why? We customarily think because of low wages. I do not think that will stand up. Japanese wages are rising much faster than ours are. But Japanese industry virtually pays no dividends to shareholders. They reinvest all earnings. Where an average American corporation will be financed by debt at about 30 percent, the average Japanese corporation has borrowed up to 75 and 80 percent. Japan is automating and cutting costs through technological improvements to a

higher degree than we are. And they will be a formidable competitor even when their wage rates match ours.

We have a partner in Japan whose productivity increased 16 percent last year and he raised wages 15 percent, so he had a 15 percent increase in wages and he was still as competitive around the world as he was before.

Chairman PROXMIRE. My time is up.

Senator Javits.

Senator JAVITS. Thank you, Mr. Chairman. I, too, found the discussion very fascinating and I congratulate Mr. Miller, who is such a distinguished, enlightened businessman in our country, and Mr. Harrington, whom I know well and is always provocative and makes a very useful and important contribution to these debates.

Mr. Harrington, I would like to ask you and Mr. Miller the same question, because it interests me greatly as a fundamental with which we are dealing. You spoke of the rich and the poor. How do you define a person who is rich? Who are the rich and how many of them are there?

Mr. HARRINGTON. I would say just for openers, roughly $50,000 of income gets you into, I believe, the upper 5 percent of the income structure. I think that would be a pretty poor rich man.

I would really define a rich person as somebody who does not have so much income as rather somebody who has wealth; that is to say, assets which can be passed on and which provide him an income whether he works or not. I have not thought too much about defining the rich. I once tried to convince a publisher I should try to do a participant observer's story on affluence but I couldn't sell the idea.

The Government defines poverty optimistically as three times the cost of an emergency meal as defined by Government scientists and as costed out by the Bureau of Labor Statistics.

Senator JAVITS. How much is that for the median family?

Mr. HARRINGTON. It is now for a family of four just over $4,100. I think it is a low figure. I think the poverty line figure should be higher.

Mr. Miller, over at the Census Bureau, certainly one of the outstanding experts, has suggested for technical reasons that we should multiply that meal figure by 3½ rather than by 3. I think our current poverty figures understate the problem.

Senator JAVITS. If you did it by 3½, how much would it be?

Mr. HARRINGTON. I don't know exactly. I assume it would get much closer to $5,000 for a family of four.

Senator JAVITS. Isn't it a fact that that is still under 20 percent of the population?

Mr. HARRINGTON. Yes.

Senator JAVITS. Now, how do you want to run this society, for the 80 percent and do your utmost to pull up the 20 percent, or do you want to run it for the 20 percent?

Mr. HARRINGTON. I don't think that is the real choice before us. I think that if you were to make a commitment in this society to provide—to abolish poverty—to provide decent housing for these people, which they don't have, decent education, decent health, et cetera—by doing that, that would enormously benefit even the rich. I think President Johnson used to emphasize this point much more than I would. President Johnson used to say, "We want to make taxpayers out

of tax eaters." I think that is a rather tough way of putting it, but I think you have an enormous market in America which doesn't exist because the people who are potential buyers and consumers in it do not have money. I think if you met the needs of the poor, corporations would benefit in this society.

Senator JAVITS. You know I am the apostle of that idea, so I cannot—like Senator Proxmire and Mr. Miller—disagree with you, though I do not think what you are recommending is going to get us there.

Let me ask Mr. Miller, how do you define the rich? Do you define them by what they have or how they live?

Mr. MILLER. Senator Javits, I think I am not far off Mr. Harrington's definition of the rich. That is, it does relate to the possession of wealth. I am not an economist and, therefore, I am very wary of giving specific figures. I think that is one of the worries I have about some of the prepared statements and testimony given here. In general, however, I am pretty much in agreement with the definitions, with the statement Mr. Harrington has given.

As it relates to the poor people, I have a feeling that in a society which can produce a good standard of living for all its 200 million members, we have a high responsibility to remove the barriers which stand in the way of those people who cannot get above the poverty barrier.

I know them in eastern Kentucky, I know a little bit about them in the Southwest, and I know that the young children born into those families have barriers which it is too much to expect them to hurdle. We have a responsibility to remove these barriers. We do not have to guarantee that they will all be successful, but we do have a responsibility to see that they have no external barriers.

Senator JAVITS. And you believe that American business, of which you are such an enlightened member, should subscribe to and undertake to do its part to underwrite the discharge of that responsibility?

Mr. MILLER. Well, I think that the Government has to be the leader. In this country, I think the role of Government has changed at least twice in my lifetime. When I was a small boy, Calvin Coolidge was President and then the role of the Government was minimum. Under Franklin Roosevelt, the Government came to be the active doer in the society. I think it is now clear that our problems are so complex and so great that the Government is not big enough to do the job. It takes the whole potential of the society and I think the Government, therefore, is about to evolve into a new role. That is the systems manager of the society.

That is why I plead for this new competence, much better facts-based analysis, genuine planning, because I think the job of the Government is to employ the whole potential of the society by a variety of sophisticated methods in order to eliminate the national problems and to promote healthy, equitable national growth.

Senator JAVITS. Now, Mr. Miller, in view of the fact that even if you set a $25,000 limit on the rich—quote and unquote—which is not very rich, but nonetheless, it is a very comfortable income—it represents only 5 percent of the population. At the other end, the poverty level—let's take the governmental poverty level—you are dealing with roughly 26 million Americans, about 13 percent of the population.

Now, what, in your judgment, is the best break for the 82 percent in the middle? How do we best approach their situation?

As a matter of fact, I might say to you that one of the big problems, and I think both of you know I am completely openminded on this, I had with Senator McGovern, who is going to be such an important figure in our country, is that he could not, to my satisfaction, tell me how he proposed to deal with the 82 percent. That is what our society is built on.

Mr. MILLER. Well, that is quite true and the bulk of all the taxes will be collected from the 82 percent, who are mostly the middle-income people. The test finally is going to be how do the people of this country feel? Do they feel it is equitable or do they feel it is inequitable? Right now, with some justice, they feel it is inequitable. I think that you have to work your way toward a balancing of that.

I have seen what happens in Great Britain when you are too strict on the top end. What results is management featherbedding and lots of cheating. So you have to avoid that extreme.

On the other hand, you have to face the fact that not all kinds of success are compensated by money in this country. Nobel Prize winners are not compensated the way corporate executives are. So money is not the only incentive to productivity.

I guess I am going to evade your question, because I cannot give you a figure. But I know in the long run your figure will be what the people feel is fair and I think you will feel your way toward that. The people in this country are pretty tolerant. If they think you are making headway and progress, it is amazing how tolerant they are of their Government.

Senator JAVITS. Now, in the remaining time I have, do you feel that we can obtain that through a pragmatic and programmatic reform of the existing system, somewhat along the lines of the very fine and most interesting example you gave?

Mr. MILLER. Yes; I think you can make major progress, but I believe that you cannot do it by basing actions on unsupported conclusions. I think they have to be based on a more solid body of fact than I think the Congress has available to it today.

Senator JAVITS. The corollary of that question was do you believe we need to go to some massive new taxing system like gross income tax or a national sales tax or value-added tax—which incidentally, I am against—or do you think our better bet is to try to do it through reform of the existing system?

Mr. MILLER. I think you are going to end up reforming the existing system and trying to make it more progressive. I agree with you on the value-added tax. I think it is hidden and it is regressive and I hope we do not follow the European pattern of concealing taxes. The taxpayer in Europe really doesn't ever see his taxes. In a democracy, I think, for all the hassle it creates, taxes had better be out in the open.

Senator JAVITS. In addition, there is the markup theory of American business which would absolutely kill us if we had a value-added tax, as anybody who has ever been in any type of business knows.

One last question. In this committee, between Senator Proxmire and myself and other Senators, we developed the concept of giving the Congress a new agency, an Office of National Goals and Priorities

Analysis to enable it better to cope with the tremendous volume of expertise in the executive department. Would you have any opinion on this?

Mr. MILLER. Yes; I would favor such a body with some cautions. The national goals and priorities in this country really ultimately rise up out of the people. They are not determined by a small group at the top. In general, wise government recognizes the emerging trends and then gives leadership to express them. In such an organization, if it is guided by a high degree of sensitivity to the real trends in the society, then it could be enormously useful to the Congress.

Senator JAVITS. Thank you very much.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Congressman Reuss.

Representative REUSS. Thank you, Mr. Chairman, for producing on one panel an enlightened capitalist and a democratic socialist. We shall never have a better chance to ascertain what the difference is than this morning.

So I would like to ask Mr. Miller first whether I understand him right. I hope I do.

You see, Mr. Miller, as one important means of realizing our national goals a continuously equitable distribution and redistribution of wealth and income. Am I right in thinking that one reason you reach that conclusion is that in order for the goods, public and private, that we are capable of producing to be taken off the market, we need consumers, particularly at the lower end of the spectrum—the poor and the less wealthy working people—with sufficient purchasing power to do that, and also, give sufficient attention to the public sector? Isn't that really, in a nutshell, the leading economic reason for a fair redistribution of income? The social reason, of course, is equity and fair shares.

Mr. MILLER. Yes, both reasons apply in our country. But both reasons must go together, because this country began not as any other country. We were dedicated to the American way, partially defined an equality of opportunity, which we are still trying to achieve. We have slipped a little bit, I think, in the last 20 years. It happens that the achieving of equality of opportunity is also going to make this a wealthier country. I agree with that.

I believe that if the South had the purchasing power of the industrial North, it would be the greatest additional market that American industry could tap.

Representative REUSS. And for there to be equality of opportunity, you feel the need for some redistribution of wealth and income, just to give——

Mr. MILLER. I feel the need for some redistribution not only in respect to the ability to pay taxes but in respect to where the taxes go, particularly to make sure that the young generation starts off without any externally imposed handicaps insofar as that is possible.

Representative REUSS. Thank you.

Now, let me turn to Mr. Harrington and ask you whether I understand you correctly, that you feel there needs to be a redistribution of income and wealth achieved by a total set of measures, not just by taxation, though taxation plays some part and that the reason for that desired redistribution is likewise twofold—equity and fairness, and

second, providing enough purchasing power and enough public sector attention to take the product off the market and to prevent Karl Marx's prediction from coming true, which was that capitalism, if it persisted in grinding down the people at the bottom of the scale and not caring whether they had sufficient income and purchasing power and public sector goods to take the product off the market, would ultimately perish. You would sooner make some repairs than have Karl Marx's prediction come true, would you not?

Mr. HARRINGTON. Well, I don't want to get into a scholarly discussion. I happen to think, and I outlined it in my last book, called Socialism, that Marx made that prediction as a young man and later took it back, and understood that personal income was rising with European capitalism. I personally think we should have as much liberal reform now as we can possibly get. I think it is a kind of idiotic radicalism that says all liberal reforms are just tinkering with the system, I will wait around until the millennium. I think we should have this reform now for the reasons you stated—equity, democratic values. Plus, I am convinced that these kinds of reforms will benefit all America.

One glows on that. I think it is wrong, if I could get back to the colloquy with Senator Javits, it is wrong to imagine America as a society in which you have the rich who have too much, the poor who have not enough, and the vast number of people in between having roughly enough. The figures we just got yesterday, I think it was, on median income in the United States indicate that a majority of Americans do not have a modest but adequate income as defined by the Bureau of Labor Statistics. That is to say our median income is a little over $11,000 and the BLS's, modest but adequate, is a little over $12,000 by now. I think the vast majority of members of the AFL–CIO, the vast majority of the working people, need this kind of attention. And I think by enacting the kind of legislation that this committee is considering by taking these subsidies away, you are going to benefit—the point is not simply to benefit the poor. That should be a prime goal of policy I think, but to benefit everybody.

Representative REUSS. Thank you for an enlightening answer.

Let me turn now back to Mr. Miller, who in his prepared statement ticked off some of the current tax loophole controversies and then said, and certainly I do not disagree with that, that we really do not know all the answers and what need is a more comprehensive approach to our fiscal problems, both on the spending and on the taxing side. I think many of us on this committee see the dichotomy in the short term and the long term as you do. However, I would not want to lose the short term, either, and it is this that I want to question you about.

I would like, on the long term, to see the President immediately, or certainly next January, whoever he be, appoint a very top level commission consisting of leading Members of Congress and business, labor, the public to come up in a year or two on a very expedited basis with some set of tentative answers to these long range problems you are talking about. Would that part of what I have in mind seem to you sensible?

Mr. MILLER. I think it would be very sensible providing that such a commission had the right mandate. To protect the President, he should have no responsibility to accept its findings. To insure a creative

commission, it should be free to come out anywhere that it wants. And, if it does its work well, intelligent, and perceptively, then it is bound to be a very useful and influential document.

Representative REUSS. I think those conditions are very constructive. Now let's look at the short term, in which we have a continued nagging unemployment and inflation, a continued public resentment against an unfair total tax system, and a continued distressing budget deficit. For example, in the fiscal year 1973, the one that just started, whereas the full employment deficit, the one that is more or less acceptable to advanced thinkers, is $27 billion, the actual deficit looks more as if it will be something $8 or $9 billion more than that, like $36 or $37 billion. Therefore, there is an immediate need for additional revenue. Additional revenues, to a degree, will come from increased economic growth, there will be a larger base and at the same tax bracket, more will be flowing in.

You speak of an overall tax increase. But I ask you, or perhaps beseech you, should we not make a good interim effort to put together some sort of a loophole-plugging tax package.

Mr. MILLER. Absolutely.

Representative REUSS. Maybe not Joseph Pechman's $77 billion, or Mr. Harrington's $77 billion, but everybody knows that there are $7 or $10 or $12 billion worth of income that now escapes the Federal tax gatherer that really should be retrieved. So should that not be a first order of business while we are undertaking this 1- or 2- or 3-year overall view process that you and I discussed a moment ago?

Mr. MILLER. Absolutely, but you should not be surprised if the elimination of the loopholes does not transfer the full amount to the Federal Government because of the interaction effects I was talking about. The taxpayers will then make different choices, jump int different directions, and it will not all come back to the Federal Government. But still, insofar as an exemption is a true loophole, it ought to be plugged.

Representative REUSS. Fine.

Mr. MILLER. But it will not all come back.

Representative REUSS. I am delighted by your answer. Of course, it will not all come back, but every little $5 or $10 billion we can pick up helps.

Mr. MILLER. However, as a long time registered Republican, I am appalled by 3 years of deficits that will total almost $90 million and I think that in itself argues for more taxes.

Representative REUSS. As a longtime Democrat, I am equally concerned about it.

Thank you, Mr. Chairman.

Chairman PROXMIRE. And as a longtime Democrat, I am especially concerned about the fact that that would represent maybe a balance in the full employment budget, but that the weakness has been that we have not used our resources. This is the problem.

If we had full employment, or not even full employment, 4-percent unemployment, which I think is much too high a target, we would not have had these deficits.

Let me announce—I should have done this at the beginning.

Mr. I. W. Abel, president, United Steel Workers, was invited to be a witness today and cannot be here. He is at a meeting most of us,

at least, are familiar with, involving the AFL–CIO. He submitted his prepared statement with the committee for the record.[1]

I do have a couple more questions of you gentlemen if you would permit it, and I assume my colleagues do, too.

Mr. Miller, you suggest a kind of a wealth tax which is interesting and it hadn't occurred to me before.

Mr. MILLER. I didn't know I had.

Chairman PROXMIRE. Your view that we calculate ability to pay as combined with net worth, implied that we might take wealth into consideration. I assume such a tax based on this would go beyond the income tax and the property tax. Maybe not. But if we do recognize wealth and tax it, can you square that with the notion of not confiscating income or——

Mr. MILLER. Yes; it is a matter of degree. There would be a degree that would be confiscatory and there would be another degree that would not be.

Senator JAVITS. If the Chair would yield on that, of course, you could qualify an exemption which is not a constitutional exemption. Could you qualify the way in which the individual does not pay his taxes so that he would have to pay from what is not an appropriational property?

Chairman PROXMIRE. Would you like to explain that so I could understand it?

Mr. MILLER. Well, I would, but I would like to hear Senator Javits' explanation.

Senator JAVITS. What I had in mind is where the taxpayer pays an inadequate tax based on net worth, on his interest, and many other things on which he has deductions. You could limit the application of exemptions.

Mr. MILLER. Yes; that is quite possible.

Senator JAVITS. And in that way recapture all or a good deal of what would be taxable on a net worth basis, so you would not have to invade a constitutional principle.

Chairman PROXMIRE. This would be a refinement or improvement on the income tax, is that right?

Mr. MILLER. I think it is a refinement of the present system.

Chairman PROXMIRE. If we go to higher taxes, you cited a situation in England in which you said you can get to a point with higher taxes on high incomes where you have featherbedding and lots of cheating. I notice that a study shows that the United Kingdom has 39 percent of its gross national product taxed. This country has 32 percent. In Japan, which you cited as an example of efficiency and progress in the international competition, only 21 percent is taxed. So it would seem that a higher rate of taxes might be counterproductive.

Mr. MILLER. Well, I think Japan is facing some problems of additional taxes just as we are.

Chairman PROXMIRE. They have a long way to go before they get up to us. Ours are 50 percent higher.

Mr. MILLER. But you have to be reminded that Japan supports no defense effort like that we support.

Chairman PROXMIRE. I understand.

[1] The prepared statement of Mr. Abel may be found on p. 67.

Mr. MILLER. That Japan is one of the most polluted countries in the world—in its great cities.

Chairman PROXMIRE. Well, all I say, Mr. Miller, is there are reasons to understand why they are able to have a lower tax rate but at the same time, their low tax rate occurs at the same time that they have this great productivity.

Mr. MILLER. That is right. They have also excluded their public service needs and I think in the next decade, you are going to find a painful reappraisal in Japan.

Chairman PROXMIRE. Maybe another answer is to look at Germany, which has also done exceedingly well and has a higher proportion of their GNP paid in taxes than we have.

You have some interesting comments about the investment credit I would like to explore briefly. Do you see the investment credit as a good incentive for increasing employment, first in the short run and then in the long run?

Mr. MILLER. I see the investment tax credit provided you do not reduce the total corporate take—is a major encouragement to industry to modernize, increase productivity, and put in effective technological improvements, and lower costs.

Chairman PROXMIRE. You do not see it relating one way or another to employment primarily, but to efficiency?

Mr. MILLER. Yes, because insofar as we improve our productivity, we then get a greater share of the world's trade. We are now becoming uncompetitive.

Chairman PROXMIRE. Even more fundamental than that, as we improve our productivity, we increase and improve our standard of living. That is the only way, isn't it?

Mr. MILLER. Yes.

Chairman PROXMIRE. If we increase wages without increasing productivity, you in effect just get higher prices.

Mr. MILLER. That is right.

Chairman PROXMIRE. If you can increase wages and productivity at the same time, you can produce more and sell more without increasing prices. And the standard of living improves.

Mr. MILLER. Right.

Chairman PROXMIRE. Mr. Harrington, you make the provocative statement that the Federal Government, including President Nixon, are now in the business of redistributing wealth. When you made that statement, you did not indicate in what way. Some might imply you meant that the Nixon administration redistributed it to the poor. I am sure that was not your intention.

Mr. HARRINGTON. What I am talking about is that I think the way in which Government economic management has been carried out, particularly in the entire postwar period, has been to stimulate corporations, to stimulate the top, for the Government, to use its power to generate income at the top and to let it trickle down. What I am saying is that that is a profound choice. When John Kennedy had a debate within his own administration as to whether to go the tax cut route or a social spending route and resolved it for political reasons—his situation in Congress—in favor of the tax cut route, I think a basic social priority was being badly served there. That is to say the Kennedy-Johnson tax cuts did increase the entire wealth of the society for

everybody, including a good number of the poor, but I think it did so by increasing the maldistribution of income in the society.

Chairman PROXMIRE. So you are saying Kennedy, Johnson, and Nixon have all redistributed the wealth of income but to the wealthy?

Mr. HARRINGTON. I am saying more than that. It is inevitable, in a Keynesian or post-Keynesian framework that the government's economic management policies are going to affect income one way or another. The question is not whether they are going to affect the distribution of income but how.

Chairman PROXMIRE. In the last 2 years, especially because of the changes in the tax structure, the redistribution of income has gone to those who have had it and who have had more of it.

The studies have indicated that there has not been much change. The income in 1960, the various quintiles of income, show it maybe a little worse. But there has not been any of the kind of improvement that you would expect in a period in which we have educated our people far better, far more people have graduated from high school, far, far more from college, yet you do not get with this greater training, greater skill, greater education reflected in a more widespread dispersion of the available wealth and income.

Mr. HARRINGTON. I would agree with you, but I would just add that I think there is an information problem. Wealthy people are much more able to avoid taxes, to hide income, to take income in the forms of deductible expenses, et cetera, than working people or poor people. So I think although the official figures give you a continuing redistribution, it may well be that the consumption in America is an increasing maldistribution of income in that period.

Chairman PROXMIRE. One final question. You argue that tax subsidies do not serve the average citizen and, therefore, we should substitute public spending programs for the tax subsidies. What bothers me is that many of the spending programs are not efficient and fair, either. This is true of social programs as well as defense spending. We are having studies made by this committee of the waste in education programs, and many of the other programs that we all favor in terms of values, but the Government just is not a very efficient way, sometimes, of achieving these ends. What is your basis for concluding that public spending programs represent an improvement over tax expenditures?

Mr. HARRINGTON. What I am saying is that I think they would not be a panacea but just an improvement in some areas. For example, I think in housing, as the recent scandals, I think you would have to call them, as HUD would indicate, they have obviously been spending money very badly. I would like to see us in the area of housing go back to that congressional commitment of 1968 of 26 million units over 10 years.

Chairman PROXMIRE. That was the Proxmire amendment.

Mr. HARRINGTON. Well, I wish we would honor it and I do not think we are.

I am not saying this is going to create the good society, but——

Chairman PROXMIRE. Don't you differentiate, or do you, between spending a lot of money and how you would spend it?

Mr. HARRINGTON. Sure.

Chairman PROXMIRE. Don't we have to find far more efficient ways of spending it? I have worked for a long time now—2 years ago I requested the GAO and the Office of Management and Budget to make a study of measuring productivity in the Federal Government. Finally they have got it. They are working on it and they are making some real progress. I think there are ways we can get greater efficiency in this area. But I think it is wrong to make the assumption that if you shift from tax expenditures to public expenditures, you are automatically going to get an improvement in public services. It doesn't necessarily follow.

Mr. HARRINGTON. I agree with you, but I have one comment. There is another myth in the society that all our problems in the governmental area come from having spent too much money unwisely. I think there are areas, and I think housing is a prime example, where we have not spent the money to live up to commitments.

Chairman PROXMIRE. I hope most of that would be private sector money, with the Federal Government using leverage with incentives.

I would like to ask, Mr. Miller, if you would like to comment on this. I am especially interested in your notion for providing, for example, exemptions in the charitable areas. For example, if we concentrate all our education in the public sector, then the private universities and the foundations and the other elements of pluralism in America are ignored and neglected, don't we lose something that is pretty important?

Mr. MILLER. Yes, we do. The Federal Government—in the area of education or welfare—must be reasonably prudent and probably will never be out on the cutting edge. In a pluralistic society, we need institutions like the great private universities who are free to innovate and lead and blaze new trails—not that they are entirely living up to their mandate today in all respects. But we need that and we need them to be able to do this relatively freely of big brother. Therefore, I think a charitable deduction of free funds available to our institutions of quality to blaze a trail are an important service to Government and Government can observe their experiences and public education can itself be improved.

A major problem with today's public education in the public schools is that it is so monolithic, it is very hard to innovate and to respond to a rapidly changing pattern of use.

Chairman PROXMIRE. Senator Javits.

Senator JAVITS. I have just one question I wanted to ask you, Mr. Miller.

As a business leader, will you tell us what caveats in a reform of the tax system we have to bear in mind, if you would agree with this statement made by Herbert Stein, Chairman of the Council of Economic Advisers. He said: "There has to be a willingness, because the nonpoor greatly outnumber the poor and dominate the political process. The fact with which all such income redistribution plans must contend is that there is a limit to the willingness of the nonpoor to give income to the poor."

Now, as a successful businessman, managing thousands of workers, what are parameters, in your judgment, that we have to bear in mind if we are not to tread a course which may prove to be regressive. There

is nothing that stops the people of this country under the Constitution from having a very reactionary government or entirely manhandling the Constitution. These are very revolutionary and dangerous times. So whatever contribution you could make to that, I think, would be very helpful. And the same with Mr. Harrington.

Mr. MILLER. I will try to give a personal response. I am very high on the American people and I think the great strength of this country has been its tradition of volunteerism. That tradition has suffered in the past 20 years in part through the growing inequities of the tax system. There does now exist a hostility—let's take between middle income and poor—which was not there in the same degree 20 years ago. Let me give you a little example from our own town, which is only 30,000 population.

In 1940, we were not able to get from the State tax board enough of a tax base to bring our school up to date. So the community wanted to build a major new addition to the high school. They skimped on the gym and put the money on the classroom. It was decided in the community that all the industrial workers should be asked to give 1 week's pay over 3 years to get us ahead on the school system. And that money was collected. I do not think that would be at all possible today. But that potential is still in the American people. I think it will return insofar as people think they are being dealt wtih equitablv and fairly. One of the big dangers today is the growing hostility and alienation that comes from a sense of inequity.

Senator JAVITS. Thank you very much.

Mr. Harrington.

Mr. HARRINGTON. I feel, Senator, a number of things. One is that I think we made a mistake—some people made a mistake, myself included—in the early days of the rediscovery of poverty by implying that the problem was one of taking from a majority and giving to a minority who were poor. I think the problem has to be defined as one in which the majority of people in America would benefit by the kind of tax reforms this committee is discussing, no just the poor; that a majority of people in America really do not have the kind of housing they should have, the kind of education, the kind of health. Therefore, you should design a program which will help the poor and so to speak discriminate in their favor because they are the people of the greatest need, but also help the working people and the middle class people.

Indeed, one of the things, I do not normally go around showering the Nixon administration with compliments, but I think one area in which he moved right was in H.R. 1 in the poverty program, trying it in with the working poor, not making it simply a program to deal with people on welfare.

So I think these programs have to be emphasized as helping everybody.

Finally, in one regard, one of the things I like about the McGovern proposals on welfare is precisely because they do that. As a socialist, I would like to certify that those proposals are not very radical at all. I am amazed they get called that. As Joseph Pechman pointed out in The New York Times, the British Conservatives are apparently considering a kind of McGovern approach themselves and it can't be thoroughly radical if Mr. Heath is going for it.

But I think the McGovern proposals do have an advantage of providing something for most of the people in the trade union movement, not just the poor. I think that is a very good principle, that in our welfare policy, tax policy, we should observe, that the principle is not to take from the majority to give to the small minority. It is a program to benefit the majority of people and will finally, I might say, benefit even the rich by creating a more productive economy, which I think will benefit absolutely everybody in the society.

Senator JAVITS. Thank you, Mr. Harrington.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Thank you, gentlemen, for a most able presentation. I think you have made a fine record, a most useful record, for us.

The committee will reconvene at 10 a.m. tomorrow, in room 1202, New Senate Office Building, to hear Prof. Edwin Kuh, professor of economics and finance, Massachusetts Institute of Technology; Gerard M. Brannon, economist; David and Attiat Ott, professors of economics, Clark University; and C. Lowell Harriss, professor of economics, Columbia University.

(Whereupon, at 12:15 p.m., the committee was recessed, to reconvene at 10 a.m., Thursday, July 20, 1972.)

(The prepared statement of Mr. Abel, submitted for the record, follows:)

PREPARED STATEMENT OF I. W. ABEL, PRESIDENT, UNITED STEELWORKERS OF AMERICA

I want to express my very real appreciation to this Committee for its invitation to be with you today.

The American Labor Movement, as you know, is not a recent convert to the cause of tax reform. In fact, the AFL-CIO has appeared before the Congress on countless occasions over the years and has presented many detailed documents for the record.

During the brief time allowed for my remarks, I simply will try again to impress upon the Congress—through your Committee—the outrage American workers feel about the inequities of our tax system. I will also suggest some remedies.

After a lifetime of association with trade union members and their families, I can assure you that they are not, and have no desire to become, tax shirkers. They expect to pay their fair share, but they insist that others do the same. They do not want special treatment, but they do want fair treatment.

Our basic concern with the tax structure is two-fold:

We appreciate the value of public services and we recognize that the Federal government . . . and state and local governments too . . . must have sufficient revenues to provide for public needs that are huge and are multiplying rapidly.

We also recognize that the tax laws at all levels of government are rigged in favor of those who already are well-off.

Clearly, there is a definite relationship between the public's view of the fairness of the tax structure and its confidence in the integrity of its government. As a consequence, we must again demand a Federal tax system that truly accords with the concept of ability to pay. We are, I fear, beyond the stage where inaction or "token" measures will be tolerated. Delay in real tax reform will fuel growing disenchantment with government and add to the growing feeling that the government is not responsive to the needs of the people. By restoring fairness in the tax structure, you will be helping to restore the people's faith in their government.

America's wage and salary earners shoulder the major share of the total tax burden. What is surrendered to the tax collector, however, cuts very deeply into their living standards, since most working people are not enjoying a very big piece of the so-called "affluence."

The latest statistics show that the average factory worker is earning about $7,950 a year, if he works full time.

The average Steelworker is more fortunate. He now earns about $10,000 a year, again assuming full time work.

The median income of the average American family in 1971 was also about $10,000, but in most cases it took two jobs to produce it.

All these figures are before taxes.

By way of comparison, the Federal government reported last autumn that a city family of four needs about $11,000 just to sustain what it has described as a "moderate" standard of life.

It is well to recall that before World War II, "earned" income . . . from wages and salaries . . . enjoyed a more favored status under the Federal income tax than "unearned" income . . . income from the ownership of property. But since then, this situation has been completely reversed. The tax burden has been more and more shifted from corporations and wealthy families to those whose incomes are modest and whose taxpaying ability is limited.

In fact, there is a triple standard applied to Federal income taxes:

One applies to ordinary income, such as workers' earnings, which are taxed in full and the taxes are regularly deducted through payroll withholding.

The second applies to income from so-called capital gains . . . from the sale of stock, real estate and the like. Only one-half of these profits is taxed.

A third standard is applied to income which never even appears on the tax form, such as the interest on state and local bonds or the income that is washed out by phantom, nonexistent costs, such as oil depletion, fast depreciation write-offs, and bookkeeping farm losses.

Under the existing tax law, for example, a family of four with an income of $10.000 would pay the following:

If its income came from wages and salaries . . . a $905 tax.

If its income came from profits from the sale of corporate stocks, real estate, or other so-called capital gains . . . a $98 tax.

If its income came from interest on state and local bonds . . . no tax.

This shocking violation of the principle that equal incomes should be taxed equally is legalized fraud at the expense of the millions whose income comes from work.

What is more, almost all of the types of income that are sheltered from the heavy burdens of "ordinary" income are those enjoyed essentially by the very rich. For example, a small group of just over one-half of 1% of all taxpayers . . . those with an adjusted gross income of $50,000 a year or more . . . receive 40% of all the capital gains income . . . a form of income which is only half taxed. And, it is estimated that this same elite group of the super well-off enjoys 76% of the tax-free benefits gained by individuals who own state and local bonds.

Less than three years ago, the Congress did, indeed, make an effort to close tax loopholes. Notwithstanding, in 1970, 394 individuals with incomes of $100,000 or more paid no taxes whatsoever. Three of them had incomes in excess of $1 million.

Corporations also enjoy totally unjustifiable tax loopholes.

Over the years, and especially only last year, American business has successfully convinced the President and the Congress that it deserves still more special tax treatment. The investment tax credit, the depreciation speedup, and a new export tax subsidy for the primary benefit of large corporations, all were enacted in 1971. These measures alone countered all the progress made in 1969 toward tax justice.

It is no wonder that whereas in 1960 the corporate share of the Federal income tax was 35%, it is expected to fall to about 26% this year. This means, of course, that working people are now required to bear even a larger share of the tax load.

The impact of last year's business tax cut binge will cause a Treasury loss of more than $80 billion over the next ten years. Yet, this incredible handout represents only one of a continuing series of actions to frustrate tax justice under the prodding of the Administration.

What is more, using the Federal Treasury as a trough for private greed, the Administration has deprived the Nation of funds to finance critically needed public investments to create jobs, rebuild our cities and improve the quality of life. In addition, these revenue losses have led to a series of Federal budget deficits unequaled in this Nation's peacetime history.

In order to resolve the budget crisis—and to thwart any effort toward meaningful tax reform—the Administration now threatens to increase the tax burden of moderate and low income families further, through a national sales tax in disguise. It is called a "Value-Added Tax," but by any name it would be a tragically regressive tax levy on all that the public buys.

What, then, is to be done?

I am neither an economist nor an accountant, but there is little doubt that the revenue losses from tax loopholes are enormous. The AFL–CIO has noted that by closing only some of the more glaring tax loopholes an additional $15–$20 billion in annual revenue would be raised. And, according to recent studies of this Committee, it appears that even these estimates are conservative.

In my judgment, the top priorities of tax justice should be an overturning of the business giveaways of the 1971 Revenue Act and the elimination of those tax preferences and loopholes which are found almost exclusively in the realm of the already well-off.

Foremost among these is the fact that there cannot be tax justice as long as earned income is taxed in full and unearned income is half taxed or not taxed at all. For example, the half tax on capital gains, and the zero tax that applies to such gains when passed on to heirs, must be ended immediately.

What is more, the special tax privileges of the oil, gas, and other mineral industries should be completely ended.

The tax exemption for interest income from state and local bonds, so dear to the hearts of the wealthy, should be terminated for all time.

The maximum tax provisions of the 1969 Act, which provide a shocking bonanza for top corporate executives and various professions, should be eliminated.

Similarly, "expense-account" living should be finally ended. Workers should not, in effect, be forced to pay for the free and fancy so-called business lunches, country club dues and stadium box seats of their corporate bosses.

In the time available, we cannot do more than mention some of the most glaring of the tax avoidance schemes.

Among the least known, yet most damaging, loopholes is the combination of special tax bonanzas provided U.S. corporations on the profits of their foreign subsidiaries.

These shocking privileges result in the loss of billions of dollars of much-needed tax revenue to the U.S. government . . . an annual loss of approximately $3.3 billion at the present time. This means that other taxpayers . . . primarily middle-income wage and salary earners . . . are compelled to pay higher taxes to make up for this huge loss.

What is more, these windfalls gravely injure workers and the economy. They amount to a Federal subsidy for the export of American capital, technology, and jobs by U.S. corporations. They undermine the industrial base of this country, cause unemployment and reduce wages and salaries. They also have adverse impacts on communities throughout the country. They erode their tax structures and consumer buying power through plant shutdowns and reduced payrolls.

These shocking special privileges for foreign investments of U.S. corporations must end. The tax deferral should be eliminated. Profits of foreign subsidiaries of U.S. corporations should be reported and taxed in the year they are earned, just as in the case of U.S.-earned profits. In addition, the tax credit on taxes paid to foreign governments should be replaced by a deduction, as a cost of doing business. This would place foreign profits on the same basis as profits earned on U.S. domestic operations.

Subsidies for the export of American capital, technology and jobs must be stopped.

I must also point out that the long-promised major overhaul of Federal estate and gift taxes is essential to the achievement of tax justice. The wealthy now enjoy a host of opportunities to minimize, postpone or entirely avoid these taxes.

Furthermore, justice demands that an excess profits tax also be levied. For as long as the Administration holds wages and salaries tightly in check, fairness requires that genuine profit control must be a part of a stabilization program, if it is to be even-handed.

In conclusion, I am confident that the added revenue tax justice will bring, plus billions more that the Treasury could collect if the disasterous economic

policies of this Administration were reversed, could underwrite a large expansion of urgently needed public facilities and services.

In addition, this would go a long way toward helping meet the budgetary problems faced by individuals and by the states and localities, as well.

In hardly any area of public concern is there so much at stake for the Nation as the issue of tax justice.

Americans have a deep sense of fairness and equality of sacrifice. Unfortunately, they do not see that fairness and equality of sacrifice reflected in the Federal tax structure. They look to their elected representatives to help restore their faith in our democratic system.

TAX SUBSIDIES AND TAX REFORM

THURSDAY, JULY 20, 1972

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10 a.m., in room 1202, New Senate Office Building, Hon. Henry S. Reuss (member of the committee) presiding.

Present: Representatives Reuss, Griffiths, and Conable.

Also present: John R. Stark, executive director, Loughlin F. McHugh, senior economist; John R. Karlik and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; Walter B. Laessig, minority counsel; and Leslie J. Bander, minority economist.

OPENING STATEMENT OF REPRESENTATIVE REUSS

Representative REUSS. Today we continue our hearings on tax subsidies and tax reform. As Chairman Proxmire outlined yesterday, the case for tax reform has been made: The tax system has lost much of its revenue generating capacity, it places a regressive tax burden on poor and middle-income families, and it has become too complicated for average citizens to understand.

Yesterday, Congressman Charles Vanik added to our general dismay about the state of the Federal revenue system by informing us that many of the Nation's largest and most profitable corporations pay no taxes or very low taxes. Among other things, Congressman Vanik disclosed that in 1970 nine of the giant corporations paid zero Federal taxes yet had total net incomes of $682 million. I encourage everyone interested in tax reform to take a careful look at the wealth of new information for which we are indebted to Congressman Vanik.

All of our previous witnesses agreed on the need for tax reform and made numerous helpful proposals about how to go about it. Today we will continue to receive expert suggestions on developing a plan for tax reform.

Our first witness, Gerard M. Brannon, is an economist recently retired from his position as Director of the Office of Tax Analysis, Department of the Treasury. Mr. Brannon received his Ph. D. from Harvard University. He has been an instructor at Boston College and Notre Dame and has been an economist with the Joint Committee on Internal Revenue Taxation, Bureau of the Budget, and the House Ways and Means Committee.

Our next witness is Mr. C. Lowell Harriss, professor of economics at Columbia University and a well known public finance economist;

has written many articles and books and is a consultant to the Tax Foundation, and is probably best known for his book, "The American Economy."

Our final witnesses are David and Attiat Ott, both professors of economics at Clark University. Mr. Ott holds a Ph. D. from the University of Maryland, is a consultant to the Boston Federal Reserve Bank, and a consultant to research project on revising the Federal tax structure. He has served as a staff member of the Council of Economic Advisers, and as a consultant to pilot study of a program of substantive tax reform.

Mrs. Ott received her B.A. from Cairo University and her Ph. D. from the University of Michigan. She served as consultant to the Treasury Office of Tax Analysis, project director of a pilot study of a program of substantive tax reform and as a research associate at the Brookings Institution. She has instructed at Cairo University as well as Clark University and was a consulting staff member to the Egyptian treasury and commerce department. Mr. and Mrs. Ott have published jointly and singly many valuable economic publications.

Edwin Kuh, who is professor of economics at the Massachusetts Institute of Technology, will not be able to testify because of other commitments.

We have very comprehensive prepared statements from all the witnesses, which under the rules without objection will be printed in full in the record.

And would you proceed, Mr. Brannon, with the substance of your statement.

STATEMENT OF GERARD M. BRANNON, ECONOMIC CONSULTANT AND RESEARCH PROFESSOR, GEORGETOWN UNIVERSITY

Mr. BRANNON. Thank you, Mr. Chairman.

I would like to say first a few things about my paper on investment tax incentives. After that I would like to talk to the general problem of tax reform.

An important argument in the paper is that these incentives, and therefore tax reform, do not really relate to the level of employment. You can have full employment with or without high investment, and for that matter with or without tax equity. Full employment depends on the total fiscal program and the monetary policy, plus our ability to control inflation. Those are important things, but they just happen to be different things from tax reform.

The second point is that with regard to the business investment incentives, we are faced with a severe shortage of information. If any witness tells you that he knows that investment tax incentives are either useless or, alternatively, the greatest invention since sliced bread, you should take his testimony with a large grain of salt.

On the effects of the investment incentives, there are two different issues on which we simply do not have enough information. One is how rapidly does the productivity of capital at the margin decrease as investment tax incentives raise the ratio of capital to labor? It is essentially the investment incentive that is supposed to increase the profitability of investment, and consequently to increase the supply of investment. As the supply of investment increases, as it becomes more

plentiful relative to other things, its rate of return is going to fall off, and to some extent offset the investment incentive. The real question is, how fast does this occur.

The other question on which we don't have enough information is, how much does the savings rate in the total society change as we increase the after-tax return on capital? The issue here is that as you provide an incentive for a particular kind of investment, if there is no change in the total available volume of savings, these investors will simply compete for the savings and drive up the interest rate. And you may get more investment in business and less in other things, but you won't change the total amount of investment unless the savings rate changes. This is the long run effect.

Now, there is conflicting evidence on both of these questions. This committee could very well see to it as one of its concerns about tax reform that more research funds are devoted to solve both of the problems.

On the basis of what I think we know about these problems, I would offer two tentative policy recommendations on investment incentives. The first one is that there is some evidence that the real return on business investment is above 10 percent of the margin. If this is so, more investment is likely to be a goal consistent with the real preferences of the American people.

This, I might point out, is closely related to an issue which this committee has worked upon earlier. That is the appropriate discount rate on benefits from public investments. If private business investments produce, say, a 12 percent return at the margin, then business investment is a better use of resources than Government projects that yield 6 or 8 percent.

My statement cites several prior hearings volumes of this committee in which this way of looking at the discount rate problem was explored by writers such as Otto Eckstein and Jacob Stockfisch, making the point that the availability of investment opportunities in the business sector at returns like 12 or 13 percent, suggests that this is a better way to use funds than to make lower rates of return, say, in Federal water projects.

The other tentative conclusion that I would offer is that in popular discussion there is an unnecessary confusion between the social usefulness of more business investment and the fairness of a tax saving for business. Now, these are in principle two separable questions. The business tax problem might be stated as, how do you get the most investment consistent with a given total tax burden on business? Investment incentives, combined with higher corporate tax rates, might be appropriately compared with no investment incentives and lower corporate rates.

There is some evidence, I believe, in recent work by Feldstein and Flemming that we would get more investments if we relied on the somewhat higher corporate tax rate combined with investment incentives.

And I might call your attention to the fact that Mr. Miller in his testimony yesterday drew attention to this possible combination, that you might well look at investment incentives as an alternative to other ways of getting to a final tax on business income. And I believe Mr.

Miller reached a conclusion somewhat similar to my own, that it is good to have an investment incentive in the package.

Now, I would like to say something briefly about the general issue of tax reform. The first point I would like to offer to you is that I don't think it is very profitable to emphasize the revenue that the Treasury would get from tax reform. I say this for several reasons. The first one is that a most useful description of the tax reform problem is the tax expenditure budget—which, incidentally, this committee has done a great deal to keep alive. That budget describes tax preferences as provisions enacted by the Congress to achieve nonrevenue objectives, just as if we had collected more money and spent the additional money on these nonrevenue objectives.

The question of tax reform, if you emphasize this concept of the preferences, is, what do you want to do about the nonrevenue objectives. Many of us would regard special tax benefits for the aged, or for oil well drilling, to cite only two, as inefficient and ill-advised ways to reach their objectives, just as some of us might regard expenditure programs like farm price supports or the soil bank as inefficient and ill-advised. In each case what is called for is an in-depth study of the particular preferences, along with alternative ways of reaching the objective.

On the aged provisions, for example, the briefest examination will indicate that these help mostly rich old people, and probably the money would be far better spent improving old age assistance, or welfare generally, or doing such things as blanketing in all of the aged under social security.

On the oil preferences, I suspect that the money would be better spent to achieve the defense objective, which Professor Erickson's paper talks about, if you spent the money encouraging the gasification or liquification of coal, or in stockpiling end-product fuels, instead of encouraging the finding of more crude oil reserves.

On agricultural programs I suspect the money would be spent better on income supports for farmers.

In each case it may prove that with an alternate program we might achieve our goal with less total outlay, and then money would be available for other expenditures or for general tax rate reduction. As you very well know from the experience in agricultural programs, this doesn't happen very often. So in effect I say, don't anticipate that you are going to have billions and billions of dollars to use for rate reduction.

I think in each case, as I said before, you have to investigate quite deeply this nonrevenue objective being sought. Tax reform, like expenditure reform, needs a continuity of effort. The idea behind this committee's collection of papers on tax subsidies is an excellent way of going about asking the question whether tax preferences give us enough of these nonrevenue objectives to be worthwhile.

Another aspect of this tax expenditure way of looking at tax reform is that this emphasizes that existing tax rules have been standing invitations for taxpayers to do things that they would not have done without the tax benefit. The existence of the favorable tax provisions on oil, for example, has had effects like increasing oil well drilling, reducing the market price for oil, and increasing the royalties on oil property. And sudden removal of the tax preferences would cause injuries to people who acted in reliance on them.

I think this goes in somewhat the same direction as my first point, don't expect a lot on the revenue. You have made situations where you have encouraged people to take different positions on the basis of these preferences, just as they would have in response to expenditure programs. I think many of these should be changed. But you should expect that they would be changed slowly, and that the amount of revenue available for general rate reduction, or for other expenditures, is going to be modest for quite a few years.

My last point on tax reform is to put in a vote for what I think is the most important single question before you. That is the problem of capital gains at death. Presently, appreciation unrealized at death is not subject to any income tax. That it pays an estate tax is irrelevant. An estate tax is by its nature a double tax. It applies to wealth accumulated out of salaries and dividends after lifetime income taxes. Now, wealth accumulated in the form of unrealized gains, however, is not subject to any lifetime income taxes at all. Relatively speaking, if you care to put it this way, we overtax salaries and dividends, and undertax appreciation.

I think this is an important issue, because this ties into a number of other issues. On the matter of taxing realized capital gains, it is not too hard for many investors to simply postpone taxing realized gains. And if you increase the tax on realized gains, I suspect that a large part of the effect will be lower realizations. There is some evidence that this occurred in 1970, when we changed the alternative rate, and imposed the minimum tax, effectively increasing the rate on realized gains. Realized gains did go down a great deal, partly due to the market conditions. But there is some evidence that this tax effect itself is discouraged realizations.

This is what one would expect if the gains tax can be avoided completely by holding the assets for estate building if there is no tax at death. Taxing at death I think opens up the possibility of a more realistic treatment of realized gains.

In addition to the fact that taxing gains at death is, I think, an important issue on its own, there are other problems that it ties into, such as the equity problems involved in the contributions of appreciated property. And the rapid depreciation, excesive depreciation on real estate, for example, you often think of being recaptured on the sale of property. If the real estate is held until death, it is not recaptured. So that attacking that one problem of appreciation at death would improve the tax situation in a number of regards.

The appreciation at death is a complicated problem. And if the Congress spent the whole year on working out that one provision properly, and had no other tax reform in its bill, I think it would be a very good year for tax reform.

Thank you.

Representative REUSS. Thank you very much, Mr. Brannon.

Mr. Harriss, please proceed.

STATEMENT OF C. LOWELL HARRISS, PROFESSOR OF ECONOMICS, COLUMBIA UNIVERSITY

Mr. HARRISS. Mr. Chairman, may I thank you for the opportunity to be here. And may I thank you and your staff even more for the work that you have done on the whole problem of Government finance,

expenditures as well as taxes, and the program you are undertaking now.

I have a prepared statement and shall touch on only a few points.

Representative REUSS. Your whole prepared statement has been received in full.

Mr. HARRISS. The reporter has it, including two supplements which I hope will be helpful.

The prepared statement includes a table, for which I do not claim credit, on the distribution of tax burdens in 1968. It appears to help, perhaps, reorient some of the discussion about who is paying taxes now. Although there may be some people with high incomes that don't pay much tax, the authors, Herriott and Miller, show that a very substantial portion of the tax does eventually fall on upper income groups The top 20 percent paying half the tax. These figures, of course, are very approximate.

I bring this up because much of the tax discussion now involves increasing revenues, and raising taxes creates problems. When Federal taxes are over a thousand dollars a person per capita, as today, they are the source of our inability to satisfy many of our wants. To raise taxes would increase the difficulty.

Most of the current proposals for raising revenue would involve taxes on capital or the returns to capital. I shall spend the rest of my time commenting on a few aspects of the role of capital and the relationship of the tax system to capital.

The term "needs" as related to capital is slippery. I would urge, however, that we try to think of the amount of capital related to expectations.

Mr. Brannon's paper for your compendium, and his comments here, included a point which might deserve more emphasis; namely, that the amount of investment is related to the amount of savings. The capital resources that we will have for housing, for jobs, for other things, will depend upon the amount of the difference between our income and our consumption, that is, net saving. The tax system now bears relatively heavily on sources that would add to the supply of savings. This is independent of the incentive point that Mr. Brannon just made.

The amount of capital per job, that is capital that will make the job produce the income which people expect, this amount is very substantial. In some cases it really is strikingly high. Your committee might very well look into the question of capital related to employment.

Moreover, a good deal of productivity increase over time will depend upon the increase in the amount and the quality of capital per worker.

I emphasize, relative to expectations, people who are going into the labor market expect incomes which require a considerable amount of capital.

A second point that deserves emphasis is that the capital consumption allowances—depreciation—the provisions made under the income tax, are based on historical costs. It is not only in the supermarket that prices have gone up. The prices of capital goods have also risen. They have gone up substantially. I am not qualified to say how adequate are the adjustments for quality improvement in the price indexes.

But the machinery and equipment index is up by a quarter or so in about a decade.

ADR and accelerated depreciation may be reasonably adequate in some cases. I simply do not know. But I would very strongly urge that this aspect of the revenue system be considered in greater detail. Inflation is not something that has been minor, that has been temporary. Nor is it something that will pass next year. It may be with us for quite a time. And a more systematic way of allowing for the increase in replacement costs for tax purposes, and also for book accounting purposes, is greatly needed.

I agree with Mr. Brannon that estate and tax gift revision—the capital appreciation aspect is one important element—certainly warrants extensive discussion by Congress. This is not a subject which can be dealt with adequately by off-the-cuff conclusions, or intuitively. And these taxes now take, annually, not quite one-tenth of the net increase in saving—the savings figures, of course, vary from year to year. Any increases in these taxes, such as taxing asset appreciation at death, would come almost dollar for dollar out of increase in capital, or what would be the growth of total capital.

Let me emphasize a point which involves the investment credit. Technological progress is likely to be embodied in machinery and equipment. Something that biases the investment system toward machinery and equipment has merit. There seems to me to be a presumption that it is desirable, as against other kinds of investment, to speed the realization of technological progress. The cost-reduction, quality—improving productivity—increasing effects of new capital equipment, may very well be a nonneutrality in the revenue system which is worthy of encouraging.

Another point relates to capital but is not limited to it. And that is the role of the attitude toward business and business taxation.

Glancing through the comments of Mr. and Mrs. Ott, I see that they emphasize more strongly a point that I would like to make. The corporation income tax, if not the invention of the Devil, is at best not a good element in the revenue system. Constructive policy, over time would try to reduce, very substantially, the reliance on the corporation income tax. In the context of 1972, reduction of the corporation income tax seems unlikely. But anything proposed for getting *x* billion dollars a year more from people through their relationship as owners, employees, or consumers of corporation products should, in my view, be rejected. There are better ways of raising revenue.

Finally, two comments on the base-broadening proposal for increasing revenue. Social security benefis now excluded are already large. When social security benefits were made exempt, almost by accident, in the late 1930's, the magnitudes were utterly negligible. But looking ahead, the benefits are rising. They are, in relationship to the double exemption for people over 65, going to create quite substantial differences in the taxes on people who are working and those who are not. Perhaps this is such a politically difficult subject that reform is hopeless. Nevertheless, I would urge that this be examined in any base broadening thinking, because the benefits are going to rise substantially.

As far as capital gains and losses are concerned, we ought to relook at these subjects in the light of inflation. I am not sure about the

"proper" significance of inflation for capital gains and losses. Nevertheless, we have had more than trivial inflation. And there is need for a reexamination of our thinking about what is an appropriate use of changes in capital values for distributing tax burdens in a society with inflation.

Moreover, a considerable amount of some capital gains represents the reinvestment of corporate earnings. The corporate income has been taxed. We do not know for sure who really bears the taxes on corporate profits. But over time, if a substantial portion of the corporate tax does rest on the shareholders, then some or perhaps all of the increase in capital values of the shares is not an untaxed gain. It is a gain that has been subject to corporate income tax.

In contrast, another type of capital gains, increases in land values, may result largely from rising population, income growth, and governmental spending on streets, schools, and so on. The justification for taxation seems to me much stronger. I raise those two points merely to illustrate that the term "capital gains and losses" includes a wide range of elements. Differences in treatment may well be appropriate—or at least deserving of attention.

Finally, at the present time there is a good deal of discussion of the role of property tax in the system. Supplements to my prepared statement include a few statements about the property tax which may be of some usefulness.

Thank you.

(The prepared statement and supplements of Mr. Harriss follow:)

Prepared Statement of C. Lowell Harriss

TAX REVISION

Continuation of efforts to improve the Federal tax system will come as a source of hope—but today with a touch of dread. Some of us have been more or less close to the seemingly uninterrupted work of the Committees on Ways and Means and Finance for decades. (My personal "involvement" as an interested graduate student began in 1936.) Reform is not a discovery of the current political campaign. Nor is it the simple adoption of proposals whose merits are self-evident.

Going back as far as World War I, there have rarely been intervals of much more than a year without active consideration by the revenue committees. And for more than a quarter of a century your Committee has challenged us, and contributed to our understanding of the broader economic aspects of Federal finances. Accomplishments to date have not achieved our reasonable objectives. And conditions change. So efforts should continue.

Yet some of the current pressure troubles me—not because the sponsors lack good intentions but because of possible gaps in their understanding of the full range of revelant considerations.

Does experience, really, give reasonable assurance that revision on the scale now being proposed can be done, *done well*, within, say, 3 years of 365 days (we'll not have a leap year) of 24—or 48—hours each? Not as I interpret the lessons of experience. Somehow, we must choose what to select for consideration first—priorities. Equally or more important will be the analysis of principles.

My comments appear in two groups. First, I touch upon specific topics of major importance. Then I discuss certain concepts. Each group includes some commentary upon underlying principles. Except for the opening section, the focus will be on *longer-run* considerations rather more than on aspects of immediate but perhaps temporary concern.

MORE REVENUE?

Tax revision debates will not be limited to issues of tax *structure* when budget deficits are large. Revenue-raising changes, however, will involve the structure. Thus two different kinds of issues are involved.

Non-inflationary borrowing

Large deficits face us. They can be criticized on the old grounds that tolerance for deficits weakens resistance to wasteful spending. And the inflation threat needs no explanation. Deficits can be financed without adding to inflationary pressure—even in an economy making essentially full use of its productive capacity. But the borrowing must be in capital markets where the funds obtained come from sources that would otherwise make these dollars available to finance industrial modernization and expansion, utility facilities, housing, and state-local government projects. Real costs of sacrificed alternatives would have to be met.

Another result of such Federal borrowing would be interest higher than otherwise.[1] "High" interest rates, understandably, are unpopular with those who pay them and some rather vocal spokesmen. The persons who receive the higher yields are rarely heard from, partly because they and their interests are diffuse and indirect.[2]

Explicit comparison of each of the three relative to interests rates and related choices would be worthy of the attention of your Committee.[3] Will higher taxes to reduce the deficit and keep interest rates down be a good "bargain"? If, so for whom? Borrowing seems to be easier than taxes—but noninflationary bargaining? Several such queries need attention. Interest being a payment for a service (or a transfer in national income accounting) seems to be a rather different matter from a tax. Much less is required initially. Those who would have to pay the taxes would not be the same as those who would pay the interest or those who would receive it. The orders of magnitude would differ. In a more important sense lies the choice between consumption (private and governmental) and capital formation.

Taxes of $100 to reduce a Federal deficit and the need to borrow would probably result in considerably less of a reduction in private saving than of consumption. Not all taxes, of course, are essentially the same in this respect.

Growth of spending: Control as an alternative to higher taxes

Before voting more taxes to reduce the deficit, or before using new private savings to finance government (consumption), another issue lies before us. the growth of Federal spending. This factor seems to me of greatest concern in looking at revenue needs. You have seen the projections of Federal spending relative to the growth of revenue. But to what extent have other Americans learned about, and thought about, the facts? Scarcely a handful, I suspect. Families and businesses do not mortgage their futures unknowingly. Yet in Federal finance is not this almost what we are doing?

The processes of spending growth will be more familiar to you as members of Congress than to us outsiders. But all of us must be concerned. What to do? How can the growth of spending be brought under "control"? "Control" does not necessarily mean "stabilization" or "decline." I simply do not know enough about the true merits of existing and proposed programs and expansion, compared with the alternatives sacrificed (in private capital formation and consumption) to substantiate wise decisions about myriads of Federal spending projects. Who does? Past decisions on spending have suffered from inadequacy of knowledge. So do present proposals—especially of the effects of taxes (and of borrowing and inflation). The political bias for more spending does not, I believe, rest on even roughly adequate knowledge of the merits relative to the true costs.

When much productive capacity is underutilized, the arguments for expansion of Federal spending have an appeal which is exceptionally tempting. Good things can be obtained at almost no real cost. Such is *not* the situation today—and *hopefully for a long future*. The good things sought from Federal spending would require real resources which would otherwise be used for private consumption and capital formation.

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[1] Matters are not quite so simple as may seem on the surface. "Other conditions" will not remain the same under the various implied situations and assumptions.

[2] Financial intermediation can make it seem that (big) banks, insurance companies, and savings and loan associations are getting much of the interest. They do—but to what extent do they keep it? "High" interest rates even at their worst (or best), are not necessarily an element which those responsible for national economic policies should consider as determining. The alternatives need to be compared—higher taxes, pressure for inflation, and less Federal spending.

[3] Price-level stability—avoiding inflation—seems to me to deserve high priority. The reasons for opposing inflation are more powerful and more pervasive than are generally recognized, but time does not permit an explanation of my judgments here. One point, however, deserves more attention than typically given it—the implication that employment and inflation are "trade offs." Inflation, however, can bring wage rate increases that by pricing some persons out of jobs create unemployment only a little later.

Taxes as a source of distress

Whatever the benefits of a spending program—definite, questionable, illusory, or negative (results harmful)—one conclusion defies denial: Higher taxes would *create* problems. With Federal taxes already taking around $1,050 per person per year—$4,200 for a family of 4—these levies, plus those of state-local governments, are undeniably a *source* of economic difficulties. They prevent us from meeting needs and desires on our own. Individually, as families, and as businesses we suffer as taxes take money from us. These are funds which we could otherwise use for the myriads of demands and aspirations of human beings today, for a few years ahead, our retirement, and for our children. Or for the company's modernization and expansion. And the more that taxes withdraw, the greater will seem to be the appeal of arguments for still more Federal spending. Deprivations due to higher taxes occur at many points—diffused but numerous.

Elements of a vicious circle exist. While eschewing alarmist extremism about the futility of the process of controlling the increase of Federal expenditure and taxation, one must recognize a rising need for greater attention is needed to the *total* results, including the effects of taxes. The advocate of a new or larger spending project will believe that the benefits would be greater (to someone) than the deprivation from the higher taxes. This Committee has made praiseworthy efforts to study expenditure issues. So it is almost like preaching to the converted to make these points before this particular group.

With all the competence—and objectivity—humanly possible, we ought to try to compare actual results of Federal spending projects (*not the dreams* of sponsors) with the actual results of taxes (marginal, least bad, and worst). How? I wish that I could suggest new methodologies. You, of course, realize that neither the revenue-raising nor the appropriations processes in Congress will serve adequately.

Before recommending that taxes be raised to pay for higher spending, we should have better evidence on the worth of spending as well as the real costs of taxes, including human aspects in terms corresponding to those used in connection with spending. To repeat, *higher taxes would create more problems.*

CAPITAL NEEDS

Expectations exceed probable availabilities

The American people expect a level of living which requires "lots" of capital. Many young people, I am certain, count upon jobs and housing and public utility services and state-local government capital facilities which call for new saving on a "large" scale. The term "needs" as applied to capital lacks precision. So do "expects" as applied to future living standards. Yet beyond any doubt Americans look forward (1) to rising levels of living (2) for a growing population.

To orient the discussion, recognizing that the evidence does not substantiate scholarly expression, let me use an admittedly imprecise statement: In the "normal" course of events in the years ahead, net new savings will fall short of the amounts required to satisfy the expectations of very large numbers of Americans for the fruits of capital. How much capital does a modest house or apartment require? How much per *good* job? Productivity improvement, expected at 3% a year or so, must call for large capital additions. The *average* investment per new telephone in the Bell System this year, I believe, is over $1,800. Young people often expect to have a phone. But how many could provide the capital?

Recently, families have been saving at a higher rate than through most of the post-war period. These funds have financed, among other things, a peak level of new housing.[4] No one of us can be sure what the patterns of saving will be in the future. But totals, I suggest, are likely to prove inadequate, partly because of the tax system.

Almost any conceivable increase in taxation, corporate or personal, would reduce private saving and capital formation. And some suggested types of the increases would have very more such result, per dollar of revenue, than would others. In general, I would think, heavier effective taxes on gifts and estates would cut net private saving almost dollar for dollar. Heavier taxes on capital gains, especially including gains unrealized before death, but not limited to them, would also bear heavily, per dollar of revenue, on net capital formation. Other differentials grow out of graduated personal income tax rates.

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[4] The failure to consume more has not been the drag on the economy sometimes implied. The savings have flowed effectively into investment projects. If consumption reverts to the rates apparently more "normal," I assume that funds for housing will decline.

Formulations of tax policy would, I suggest, benefit from (1) careful projections of capital "needs" (2) compared with probable supplies of net new saving and (3) then explicit attempts to consider the effects of alternative tax policies on sources of net savings. To the best of my memory, most formulations of tax policy have rather overlooked such considerations.[5] Data of the kind indicated are at best subject to a wide margin of error. My own efforts to estimate capital "needs" and availabilities of new savings have been crude and far from what Congress and the public ought to have. Something better could certainly be obtained, given sufficient demand upon the part of Congress. An undertaking of this sort might logically constitute a valuable contribution of your Committee to the work of the Congress.

Capital and job creation: Is aggregate demand enough?

Aggregate demand, this, we are told (and teach), holds the key to employment. But wrong! Not "the" key, but one of the essential elements. Employment requires more than (1) dollar aggregate demand (2) appropriate to the wage rate (plus fringes) (3) at which people are willing to work and (4) able to produce.

The employer (private or governmental) must have other factors of production—machinery, tools, factory and store and office space, inventory, and financial working capital. At any moment, sometimes more so than others, employers have these essential complementary productive resources, in proper proportions, unutilized. A rise in demand will then mean more hours worked.

Over the years, however, the situation is significantly different. On the supply side for employment, capital must be available, first dollars, after that the real resources they buy. Given (1) the state of technology, (what is physically possible in terms of machine capacity, energy, transportation, communication, etc., etc.), (2) the prices of such factors, and (3) the ability and willingness of employees to work, then (4) there will be some combination of (a) wage rates and (b) product prices which will make hiring attractive. Think of one industry after another, including professionals and self-employment, and try to imagine the full capital to support a $9,000 or a $12,000 or a $15,000 job a year. The amount required per worker is "large." Employees expect compensation (fringes included) which calls for total output per worker that is possible only with thousands, or tens of thousands, of dollars of capital per person.

Depression conditions led economists to emphasize the vital role of demand as a requirement for employment. For decades, however, other essentials have too often been overlooked, that is, taken for granted in discussions of employment policy. The capital, we could assume, would be forthcoming. Much, certainly. But enough??? (1) The labor force grows, (2) And as pay expectations go up, the non-human capital needed per job tends to go up (recognizing, of course, that improving skill, education, motivation, devotion to the job, and other human elements can also contribute to "validating" higher pay expectations).

Tax policy, I repeat, should give more attention than has been fashionable for years to the supply of new capital.

BUSINESS TAXATION

Discussions of tax policy continue to reflect misconceptions whose survival power bodes ill for ourselves and our children. Widely accepted, but erroneous, views about "business" taxation impede improvements which would reduce the adverse effects of taxation on economic progress.

Anti-business and anti-capital attitudes seem to me to be spreading. In spite of the evidence! Never before has the system provided so well for so many.[6] Although almost fashionable criticisms of business reflect distrust and hostility (and gross misunderstanding), insistent and growing demands press the business system to do more on many fronts. But with heavier taxes!

Men and women whose good-will cannot be questioned, speak and write and vote as if they believe that business taxes are not "people taxes." Time and again

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[5] Some of our present structure reflects beliefs, growing out of stagnationist fears of the Great Depression, that the economy tended to oversave. Steeply graduated personal income and death tax rates were then defended as helping to offset potentially dangerous oversaving.

[6] "Consumerism" and "environmentalism" account for some of what seems to me a rise in anti-business sentiment. Such attitudes can spill over into tax policies which will impede, rather than help, business do the job for which we expect more and more.

we have heard that corporation and personal income tax changes ought somehow to be "balanced."

Policy decisions, of Congress and the Executive Branch, have been defended, in part, on a "phony" so old that its vigor today must make one wonder about man's desire to deceive himself. Taxes on corporations are interpreted as presumably not hurting people. Speakers ignore the basic reality that all taxes must be paid by human beings—as consumers or as recipients of payments for the services of labor or property.

High priority in tax revision should, in my view, center on tax changes to improve the productive system. Occasionally one hears of more than flirting with the possibility of halting economic growth. Somehow, to avoid the unpleasantnesses associated with economic change, someone seems willing to (have others) give up efforts to raise GNP. The realities are utterly different. Our ability to improve the quality of life, viewing it as we individually prefer, will be greater, the larger is the total of output (defined with increasing precision). The bigger our real incomes, the easier we shall find it to reduce poverty, clean up the environment, finance education, improve health services, finance art and science, reduce the deficits of the wide range of worthy non-profit organizations from whom we get moving appeals daily, and so on.

The role of business.—Businesses, whether or nor not incorporated, are the organizations upon which Americans rely for most of what is produced. Business is the public's major agency for organizing labor and capital to produce—and to produce more, rather than less, efficiently. Businesses are *groups of people* seeking to benefit themselves by serving others. It is this service, whether in producing and distributing *things* or in rendering *services directly*, which the public wants.

The process of meeting the desires of consumers can be more or less *efficient* in terms of inputs per unit of output. A market economy relies primarily upon competition in markets to induce efficiency—and to continue progress. For it is in business organizations that we find, not only the source of more of the old, but also most of the venturesomeness which leads to the innovations that contribute much to rising living standards.[7]

The total accomplishment of people working as business organizations will depend upon many things: the training, inherent ability, and acquired skill of workers; their williingess to exert effort; the amount of *capital*—(1) in the physical sense of buildings, equipment, and inventory, and also (2) in the financial sense of money, without which transactions as we know them would rarely be possible; the degree of competition; present and expected demand; the state of technology and speed of scientific advance; the competence of management; and "other things." Among the other things are some for which government is responsible. The system of law and order is one. The tax structure is another.

Taxes as impediments.—Taxes are *obstacles* in the sense that they take from the taxpayer without directly giving him an equivalent. They do more than raise revenue. Do these effects contribute to or hamper the achievement of the basic goals of the economic process?

Do taxes on business earnings help the community to get the output most desired? Obviously, taxes which vary among corporations according to profits do not improve the process by which consumers indicate the relative importance of their many desires. Nor do taxes on business income help managers learn about the relative scarcities and productivities of inputs. Profits taxes do not relate to the inherent creativities of different resources or act to offset deficiencies in the market's guides as to relative scarcities. But taxes *do* affect the alternatives which a business manager must consider, the incentives open to him when acting for the company.

A business, in fact, may wisely adopt methods which as regards the use of resources are "second best." The tax factor makes some alternatives financially the best when in a more real sense they are inferior. Taxes at high rates thus give rise to an element of conflict between private and public interest. They induce the manager to redirect the firm's activities, away from what is fundamentally most efficient.

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[7] The public interest calls for each business: (1) To turn out products or services which are wanted more than something else, as reflected in freely made consumer decisions expressed in the market, or through government agencies. Part of this task of business is to anticipate, identifying wants which can be satisfied by new types of goods and services. (2) To produce by methods which economize on labor, materials, capital, and other "inputs" according to their relative scarcity and productivity.

"Profit" as cost.—A business must have equity capital (ownership as contrasted with debt). Supplying it costs something. The stockholder sacrifices the opportunity to use his wealth in some other way—lending or buying assets such as real estate. Such sacrifice is an economic cost. Although income tax law and traditional accounting do not recognize this cost as a deductible expense of doing business, consumers of the output of corporations will not get equity capital to work *for* them—and employees will not get equity capital to work *with*—unless the benefits which will equal those obtainable elsewhere.

A "normal" after-tax return on equity capital is an *essential economic cost.* The net after-tax yield which a supplier of equity capital will insist upon, in expectation, will be as high a yield (conceived broadly as a total net benefit, including a rise in the value of common stock, perhaps to share in economic growth) as he could obtain from any alternative use of his funds.

The corporation will not succeed in selling new stock unless the prices which it expects from its customers will bring an adequate after-tax yield. The expansion of output (in a growing economy) will lag until prices *are* high enough to give profits which after tax do satisfy investors. In relation to demand, the supply of output from corporations adjusts to affect product prices. Over the long run, then, some or much of the corporation income tax will be paid by consumers. The indirectness of the process conceals most of it; but the result does include a tax on consumption. Some tax, however, will fall on shareholders whose expectations have been disappointed perceptibly. The tax falls capriciously, unevenly, and not in line with any concept of fairness familiar to me. Corporations producing products for which the demand is not growing may never be able to shift an *increase* in a tax rate.

What to do—for the near and the longer term

First, as shown by three special studies in the *Compendium,* Part 3—those on ". . . Petroleum and Defense." ". . . The Timber Industry," and ". . . Real Estate Investment," if any showing were needed, "business" includes widely diverse activities. The diversity throughout the economy, and the effects of present tax provisions, probably exceed anything which the human mind can understand. To me it seems worse than hopeless to attempt to make wise policy of business taxation for the economy as a whole by tailoring the tax system as it applies to different types of industries and firms—large or small, manufacturing or extractive, finance or commerce, rural or international, housing or regulated utility. In principle, I endorse broad action applying generally.

Our goal as the years pass, it seems to me, should be a gradual reduction in the 26% surtax. Eventually we could settle on a rate around the present 22% of the normal tax. This level would be not far from that applying to much personal income. Space does not permit me to develop my reasons for these numbers.

The increase in business earnings as the economy grows would maintain revenue to "finance" gradual rate reduction.[8] Whatever the possibilities of significant corporate rate reduction, and at the moment they seem dim, decisions for the immediate future must be made. Some reform is needed—and, I hope, possible.

Depreciation provisions of 1971 (ADR) and job development credit

Criticisms of the depreciation and investment credit provisions enacted in 1971, you know, have become part of the current political campaign. You have in the *Compendium* a study of the investment credit. An extensive literature deals with depreciation. I cannot claim expertise to draw upon in helping you to evaluate this evidence and analysis. I do, however, urge three points, in addition to the one respecting capital needs.

1. A bias in favor of new equipment and machinery reflecting the most modern scientific developments will be speeded. The utilization "earlier" of more and better types will bring the fruits of technological progress to the public earlier.

2. Another change in the "rules of the game" would add uncertainty. Even if not followed by action, proposals to reverse some of the changes would, to some extent, hurt the processes of business decision-making and new capital invest-

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[8] For larger revenues, we would look to the personal income tax. Real personal income, and thus ability to pay personal tax, would be greater than if the corporate rate were kept at the present level.

ment. In general, is it not sensible for government to reduce rather than increase the disturbances which it creates for business?[9]

3. Inflation affects not only the housewife. For individuals the economy may, or may not have done reasonably well in granting higher earnings, larger personal exemptions and standard deductions, increases in Social Security benefits, higher interests rates, and the making of other adjustments. For businesses, tax laws have not faced up forthrightly to the problem as concerns capital consumption allowances. We still compel the use of historical cost.

Inflation and depreciation allowances[10]

Housewives and union members, "liberal intellectuals" and antibusiness groups in general, should certainly see and understand that it is not only in the supermarket that the dollar has lost buying power. Cannot we hope for discussion of the depreciation-inflation issue on a plane of responsibility higher than typical today where "business" is involved? Leadership from this Committee might make a constructive difference.

The "machinery and equipment" element of the Wholesale Price Index of May 1972 was about 28% above that of 1960 and one seventh above 1968, only four years ago. The Producers' Durable Equipment portion of the Gross National Product Deflator is more than one fifth above that a decade ago.

Historical cost as the basic for computing depreciation results in treating some of the return *of* capital as if it were return *to* capital. The tax law then takes 48% (plus the net State tax rate) of what the law calls profits. These, however, are not limited to the true and real earnings of capital. The tax law treats as income, not merely the *fruits* of capital, but in fact includes part of the *source* of earnings. When critics of relaxation of depreciation provisions speak of the "interest-free loan" from government to business, they might consider the fact that no small number of firms has been making, not merely "interest-free loans" to the Treasury but *forced contributions of capital.* Literally, we have for years been sending to the Treasury, as tax on *earnings,* funds that in the basic economic sense are *costs.* These include dollars which are needed to replace productive capacity at higher prices. As a result, in our government expenditure we are to some extent *consuming capital.* In other words, the spending of revenues from the tax on business earnings is *not merely* using part of the annual *produce* of capital but some of the capital itself.

This result of inflation ought to be faced forthrightly. Perhaps the amounts now allowed under ADR are moderately adequate in some cases. I certainly do not know how much. Could any human being possibly judge for the range of industry of our economy?

Recognizing what is obvious—that inflation has made historical cost obsolete—Congress, the Executive Branch, and business representatives should be able to progress toward a more rational treatment.

BROADENING THE TAX BASE

To lower tax rates

Taxes have effects other than separating the taxpayer from his dollars and sending them to the Treasury. Individuals and businesses alter their behavior in response to taxes in the hope of reducing the amounts payable. What are inherently second- or third-best alternatives can become best when tax considerations are taken into account.

If tax *rates* are *low,* and if *differences* in tax rates are *small,* then altering behavior to save taxes may rarely be worth while. But when rates are as high as some are today, and when differences are as large, efforts at tax avoidance (and evasion) frequently become worthwhile. The results of such action can bring general losses to society, "excess burdens."[11]

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[9] Perhaps we might dream—for a moment—of a time in which, with good justification, the business world could feel that government was really on its side. Imagine conditions in which the open, announced, and sincerely felt attitudes of government—lawmakers, policy officials of the Executive Branch, and the bureaucracy—were truly favorable to the productive system. Can any of us, really, envisage an environment in which something in the tax world favorable—or less unfavorable—to the business system was not thought of as a "giveaway", a disreputable outcome of selfish transfer to a few at the expense of the many? No one respecting realities today can have much hope for such dreams to come true. But at least we *can* urge one constructive action—to avoid creating new difficulties.

[10] See George Terborgh, *Essays on Inflation* (Washington: Machinery and Allied Products Institute, 1971), especially Ch. 2, 3, and 4.

[11] Assume that the best alternative would produce 100 of which 60 would go in tax, leaving 40 for the taxpayer. The second best would produce 80 of which tax would be 31, leaving the taxpayer with 49. Society loses 20, and the Treasury gets 19 less; but the taxpayer has more. Moreover, in this example the higher tax rate has *negative* revenue results.

High tax rates produce undesirable results. We cannot identify all of them. We are certainly unable to measure them. But we would be better without them. Here are solid reasons for urging the reduction of highest tax rates.

Equity reasons can add to force of arguments for reduction of the highest rates. Burdens of rates at, say, 3 or 4 times those on some income may seem inequitable.

One way to permit *rate reduction* (without change in total revenue) is to *broaden the base*—reduce exclusions and deductions. By doing so, the country could improve its "economic framework." Better conditions would exist for carrying on the affairs of production and consumption. The adverse effects of high tax rates would be lessened. Not all benefits could be predicted with assurance. But logic, and familiarity with ways the economy functions, could leave no doubt that there would be benefits in the form of (1) productive capacity closer to the forms indicated by the underlying forces of economic and technological possibilities and (2) higher levels of real consumption.

Unfortunately, the impossibility of pointing to all advantages and demonstrating their amounts would add to the difficulty of enlisting support for this kind of proposal. Obstacles to persuasion are complicated immensely by the intangible nature of some present losses ("excess burdens"), and then of their opposites in benefits from tax rate reduction.

Moreover, a base-broadening-for-rate-reduction program, even though planned and advertised as *not altering total revenues*, would change the taxes for *some* families and businesses. My personal observation—not offered here as being of high probative value—suggests that taxpayers put a high value on deductions and exclusions. Who does not have friends who speak, almost lovingly, of "my deductions"? These are obviously of worth—"assets" of value in terms of dollars and deserving of emotional attachment. Giving them up for the prospects of a lower tax rate might seem to be a poor bargain. Some will almost assuredly get no net benefit. For many, the present system will probably seem worth more than the probable trade.

1. What exists is known. Uncertainties exist about change. No one can be sure that would emerge from the final stages of a Committee on Conference, IRS regulations, actual enforcement, and judicial processes. In some cases, having made adjustments and commitments on the basis of the present structure, readjustment to a new one would involve trouble and expense.

2. Some taxpayers would be made worse off. Not everyone would be in a cluster near the average. Those who definitely expect to lose would have incentive to oppose.

3. Perhaps a large majority near the average would be indifferent.

Could those destined to benefit appreciably be enlisted to support? A rational man would hope that this undertaking would be feasible. Much might hinge upon the precise details. Since rather few taxpayers might expect to gain much, strong supporters would not flood Congressional mails.[12]

A more thorough study some years ago of the "gross income" type of alternative (as suggested, among others, by Senator R. Long)—and these proposals are not exactly the same—led me to two conclusions: (1) Many of the present provisions, *do* have merit, persuasive if not conclusive. Many of us, starting afresh and judging as objectively as possible, might come out on a side different from that of Congress. But trying to get broad consensus for change would require the overcoming, not only of (selfish) vested interests, but also of arguments which have merit.

4. "Lower" tax rates might not stick. The public, including articulate groups which are anxious to accomplish what they believe would be desirable objectives through more Federal spending, would cite high tax rates and large differentials as "normal." Have we not had them? "Imagine reducing tax rates on large incomes when social needs must be met." If the notion of what is somehow right is that income tax rates should be in the range of the last 30 years, and if "proper" rate graduation is felt to include differences of 3 times or more, and if spending growth is advocated, the source of funds may seem evident. Go back toward tax rates such as we had for over a generation.

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[12] The fact that commitments have been made on the assumption that deductions will continue gives reasons for taxpayer desire that the deduction not be removed. Whether or not truly justified on grounds of implied "moral commitment" and economic results, the argument is made that long-established tax policy should not be changed. One of the largest economic commitments of certain families is the purchase of a house on mortgage. The income tax aspects will often have played a part in the calculations.

To increase revenue

Base broadening can be associated with revenue increasing. Such is the case today—almost exclusively in public references. The arguments against "tax subsidies" and "tax preferences," for "closing loopholes," are now mustered in support of increasing revenues.

The growth of spending becomes the result of base broadening. The quality of benefits from such spending may present quite different evaluation problems from those of tax rate reduction. If more revenue is to be raised, perhaps emphasis should be put upon means that will get relatively large amounts from persons who have by some standards been undertaxed. In principle, the appeal to reach some presently untaxed receipts carries weight. The *specific elements* must them be examined.

The *Compendium* has papers on three, state-local bond interest, realized capital gains, and the interest element in life insurance. Among these and others—capital losses, contributions, state-local taxes, medical expenses, interest on personal debts, the standard deduction, imputed income of residences, expense accounts, and so on—I shall limit myself to capital gains and losses and Social Security benefits.

Social security benefits

Life is short. Political life, even shorter, can be shortened still more by espousing unpopular causes. One such cause might be the proposal to include Social Security benefits (above the return of wages on which the beneficiary paid tax).

Yet the amounts are growing—in total and for individual recipients. You well know the increase voted to begin this autumn—20% plus automatic escalation. Looking ahead, we see a growing group over 62 or 65 who will have more than modest retirement incomes from sources not previously taxed. The untaxed income will rise.

The double personal exemption for persons over 65 will presumably continue; for a retired couple, the exemptions will equal those of a working man with wife and two children. Should there not be concern over the difference between taxes on working people and those retired? [13]

CAPITAL GAINS AND LOSSES

Whatever anyone—the newcomer to the study of taxation or the veteran of decades of debates—may say about reform of the tax treatment of capital gains and losses, issues are inherently difficult. They do not lend themselves to simple and clear-out solutions. Income is a flow, the fruit. Capital is a stock, the tree (corpus). They relate. But they are not the same. To blend them for taxation requires a certain amount of *force majeur*. Let me touch 4 points.

1. Our thinking about the taxation of capital gains and losses should examine carefully the reality of *inflation*.

Capital values represent the present discounted estimate of future income. Capital values reflect, among other things, changes in the worth of the dollar. In a world of inflation, increases in the prices of assets do not necessarily represent improvements in real economic position. A capital loss on an asset owned for a decade or more may grossly understate the decline in real economic position due to the ownership of the asset.

Academic discussion of the tax treatment of capital gains and losses has tended (1) to disparage the reality of inflation as a significant factor and (2) to focus on *relative* economic position (persons with and those without capital gains and losses). A new look now should take account of the price-level changes of recent years and the possibilities ahead.

2. If tax rates were reduced materially, the reasons for distinguishing between changes in capital values and regular income would lose much force. Some proposals for tax reform do provide for general rate reduction and broader coverage of gains. The inclusion of more gains in the tax could help to make rate reduction more likely. (Losses, however, would operate in the other direction.) A large range of simplification could be made. This general approach has merit, potentially great merit.

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[13] When the original administrative decision to exclude Social Security benefits was made, the amounts that might have been taxable were negligible. No one could possibly have foreseen the vast changes of the last 35 years. If, as may well be the case, much of the tax paid by the employer is shifted to the employee (as worker or consumer), how would our conclusions about appropriate taxation of benefits be affected? This is one of the questions deserving more study.

Short of that, I would emphasize points somewhat different from those in the *Compendium* paper. The relations of the tax to capital as a productive resource seem significant; they do conflict with considerations of equity among taxpayers. On the one hand, it seems unfair to ignore a (realized) gain or loss in deciding how much one person shall pay compared with others who have only wages, interest, or other types of ordinary income. On the other hand, it seems foolish for a society which needs capital to reduce the amount in private ownership when a person sells certain assets (perhaps reinvesting the funds). In addition to what I say elsewhere about capital, I add two points of many bearing on this complex subject.

3. Let us distinguish capital gains which accrue over the long run from those due to month-to-month and year-to-year changes which can result from many temporary and passing forces. The true rises over long periods are due to considerable extent to the reinvestment of corporation earnings. As shares of stock appreciate over the years, some, or much, of the rise represents the plowing back of profit. And that profit has been taxed to the corporation. Therefore, some of the base of capital gains has been taxed. (Stock prices also go down, leading to capital losses despite the corporation's payment of tax on earnings of good years.) Of course, to the extent that the corporation tax is shifted to consumers, this point loses validity. But to the extent that the tax on corporation earnings rests upon suppliers of equity capital, then the base for the rise in share price has been taxed. The implications for capital gains taxation may not be fully clear—they are not to me. One major conclusion, however, will be that the capital gain as a return to the supplier of capital in the form of asset appreciation is an *after-tax* return. As shares are sold, some of the realized gain has already been taxed. Recall—we deal here with the long pull.

4. Another source of capital gain is the rise in land prices (above the owner's inputs of capital for drainage, landscaping, and other improvements of the land). Some will be holdings of individuals or unincorporated businesses. Some will be embodied in the prices of corporate shares but not as a rule havé been subject to corporation income tax. No personal income tax will have been paid on whatever causes the rise in land prices.[14] The reasons for taxing a capital gain in land price seem to me much more persuasive than those of share price increases which result for the reinvestment of taxed corporation earnings.

EQUITY: JUSTICE: FAIRNESS

The search for equity—or, as problems often appear, avoiding inequity—in financing government deserves our unending efforts. The history of 1969 gives testimony, if any were needed, of the force—a wholesome one,—of the desire for tax equity.

Aspects of the concepts and their meanings

Some matters will seem clear with a general consensus (among those with knowledge) that certain features are inequitable (the homeowner-renter discrimination or the failure of the estate tax to differentiate according to number of heirs, but without agreement on what ought to be done. Often there will be honest difference of opinion about whether some condition really is inequitable (the relative treatment of married couples and single individuals). Resistance to reform may come with spokesman's frank admission that continuation of the inequity is preferred to any feasible alternatives. Sometimes there is little more than hypocritical rationalization, perhaps only "let's talk about something else." Or, as with the increase in the standard deduction to ease compliance and administration, there is forthright recognition that equity is not the only valid consideration. Often there is doubt about what "equity" is, *e.g.*, the limit on the deduction of capital losses.

The terms "equity," justice." and "fairness" as applied to taxation require more careful thought than often seems to underlie the casual, intuitive impressions on which people rest conclusions. The terms have several aspects.

Enforcement of tax law.—First, an aspect on which there will be a consensus: "Every taxpayer shall be treated according to legal rules which apply equally to all taxpayers in the same class." Fairness requires that there be no prejudice, whether by accident or design, in the application or administration

[14] Annual property taxes may have gone to pay for community services and facilities which make the location more valuable. The property taxes paid will have been deducted for income tax purposes. These local taxes do not warrant a second recognition.

of the law. The higher the tax rate, the greater the practical significance of this point.

Graduates in differentiation of tax burden.—A general principle distinguishing the equitable from the unfair is associated with continuity and gradualness. Big changes, big breaks, large discontinuities are more likely to be a source of injustice than of justice. It seems unfair if slight inequalities in personal position create large inequalities in taxes. Justice calls for tax *inequality*, but it also requires that the inequalities be related to *differences that have substance.* A relatively small and insubstantial difference should not give rise to a substantial difference in tax.

If getting on one rather than the other side of a line makes a big difference in tax, the possibility seems more inequitable than equitable. Some discontinuities, of course, may be a reasonable price to pay for ease in administration or some other desirable objective. In general, however, slight differences in conditions ought not to lead to big differences in compulsory payments for government. Some of the conditions may be under deliberate control.

The tax system contains scores—or hundreds—of provisions under which much tax can hinge upon a slight difference in circumstances.[15] Legal draftsmanship, for example, can override economic and human substance. One reason for cutting tax rates and broadening the tax base is to reduce the opportunities and dangers of such inequities.

Benefit from government spending.—Equity or justice as "giving every man his due "supports the benefit (*quid pro quo*) doctrine. The cost of governmental services should be apportioned among individuals pro rata to the benefits derived.

But governments perform functions of which the benefit is either entirely or largely *collective* so that it cannot be apportioned individually or by groups. And many programs, especially those involving transfers, are *intended* for purposes other than equity in this sense; we seek the benefits of humanitarianism, better productivity, social harmony, a different kind of farm economy, and so on. Reward according to contribution, desert related to merit—justice and equity in this sense—receive little attention (and less that is favorable) in current discussion of Federal financing.

Two examples of current interest can be cited. (1) Cost-bearing of Social Security on an equity basis, more or less along the original lines, has been subordinated extensively in practice—and many observers would go even farther—in favor or a "welfare" or redistributional basis. (2) Concern over greater use of charges, fees, and other self-liquidating sources rests in part upon a belief in fairness; in addition there is in some cases support on the grounds that relating cost to use can serve a constructive purpose in limiting the quantity demanded.

Space restrictions preclude discussion of the potential use of the benefit principle in Federal taxation.

Horizontal equity.—Another criterion will elicit widespread agreement—*horizontal equity.* "Equals shall be treated equally." Everyone on the same income level, or consuming about the same things, or owning about the same amount of real estate in the locality, and otherwise in essentially similar circumstances, shall bear the same portion of the expense of government. When their circumstances differ in *ways that are significant for the sharing of the costs of government*—size of family or total of charitable contributions, for example—fairness requires that tax loads differ. This principle lies at the base of many of the most debated issues.

Vertical equity.—A perplexing problem appears as we face *vertical equity.* People whose circumstances differ in ways that are relevant for sharing the costs of government must pay different taxes. *How much* of *what* differences will warrant *how much* difference in tax? Little consensus will be found—except that the unequal treatment of taxpayers must rest on reasonable, not capricious, bases. Is income a relevant factor? place of resident? wealth? health? source of income? effort made in getting income? weight or color of hair? age? and so on. Since many of these and other elements *always* appear, how must each be weighted? For example, do we achieve vertical equity in taxing more heavily the

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[15] For examples, see "Sources of Injustice in Estate Taxation," reprinted in C. Lowell Harriss, *Innovations in Tax Policy and Other Essays* (Hartford: John C. Lincoln Institute, University of Hartford, 1972), pp. 207–231.

$16,000 than the $15,000 income when the extra $1,000 resulted from the sacrifice of leisure and the input of more working hours?

Ability-to-pay: A useful guide to equity?—Suppose that everyone here, or in any group, were asked to write out his or her concept of "ability-to-pay" as applied to taxation, in sufficiently concrete terms to serve "operationally," in practice. One response would be a "begging off" from what in fact is more difficult than easy. Another result, I predict, is that no two answers would coincide. Please do not ask me for an "operational" definition.

In any case, however, does "ability-to-pay" conform to "equity"? In examining this question, is it not relevant how the "ability" was obtained? Two families, for example, may each have $12,000 earnings and be essentially the same in family size (and traditional deductions). By common opinion, I assume, it would be thought that they have the same ability-to-pay. Is it necessarily fair to tax them equally? If one father worked 1,800 hours and the other 1,600, is equal taxation equitable? The dollar equality (the objective factor) does not exhaust the issue. Now assume that one has $14,000 from 2,000 hours at $7 each, while the other has $12,000 from 1,500 hours at $8 each. The first presumably produced more as he worked more. His money income—and dollar ability-to-pay—is larger. Is it equitable to force the one who contributed more to the flow of goods and services also to bear more of the costs of government? Even more perplexing, perhaps, will be the question of rate graduation. Is it equitable to apply higher tax rates to pay received from more work? How do the differences in objective ability, dollars, come into existence?

People can acquire differences in ability-to-pay in other ways. Suppose that over the years one family saves more than the other (out of equal after-tax incomes) and gradually builds up a base of capital. This yields money income as contrasted with the memories of higher spending from the other. The two, I assume, have different abilities-to-pay. But is it *equitable* to require the one that has saved to contribute more to the costs of government? Why? Are there non-equity reasons?

Observations on progressive taxation.—Many Americans are still poor. Humanitarian considerations alone must be highly persuasive in any discussion of taxing them (taking account, of course, of the effects of government spending). Is not an improvement in the conditions of the poor a mark of genuine social progress? Government policies of taxation and expenditures, as well as in other respects, can make a difference, good and bad.

In arguing for heavy reliance upon personal income taxation, one cites that is is one major levy which can exempt the poor.

And one does not have to base support on hard-to-define considerations of fairness or justice. Mercy and compassion suffice.[16] Whatever we think about tax discriminations *against* those with high incomes—the "soak the rich" support of progression—many of us will endorse the aspect of progression that affords tax *relief for those at the bottom of the income scale.* The personal exemption can do so. An income tax with an exemption will accomplish this end, and can do so with a flat rate—or even with regressive rates.

A solid basis for policy is to exempt a minimum of income. Doing so will then almost certainly assure progressive burdens through a range of income which includes most Americans even if rates are proportional. Thus specific exemptions and a flat rate up to, say $8,000 of taxable income can yield quite a bit of progression and cover most of the total population.

We have done a good deal along these lines. Another aspect calls for study—a graduated rate structure with bracket widths in real terms reduced by inflation. Rate graduation that may have seemed fair at one time has significantly changed as a result of inflation.[17] Even so, when larger income results from more extensive and higher quality personal effort and contribution to the general economic benefit in output, is it not wrong from the standpoints of both justice and economic efficiency to penalize such effort?

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[16] An opposite consideration may be noted. Will persons expecting to be free from (more) taxes be more inclined to favor expenditure increases? The not unimportant issue of responsibility in the growth of government spending may be related significantly to voting power of persons who expect to be free from (much) requirement to bear the cost.

[17] Equity, of course, is not the only consideration to be taken into account in judging rate graduation.

Share of total tax paid by each quintile and top 5 percent of families and unrelated individuals—1968

	Percent
Lowest quintile	3.7
2d quintile	9.4
3d quintile	15.2
4th quintile	22.1
Highest quintile	49.6
Total	100.0
Top 5 percent	24.8

Roger A. Herriott and Herman P. Miller, "Tax Changes Among Income Groups—1962–68," *Business Horizons*, Feb. 1972, p. 42. From 1962 to 1968 the shares paid by the 3rd & 4th quintiles went up one percentage point each and that of the top 5% fell by 3 percentage points.

Personal income tax rates and brackets combine to create a *scale* of burden differentiation which calls for more attention than is yet evident. As the campaign proceeds, however, there will apparently be 2 kinds of arguments from at least one side—that because of loopholes *some* people in upper income groups are not paying as much as others and that the group as a whole ought to pay more. As to the latter, data for the country as a whole covering all taxes in 1968 are of interest. The top fifth are shown as bearing half of the *country's total* taxes. The top 5% carried one fourth. *Statistics of Income*, of course, leave no doubt that the high rates *do* apply. Space does not permit presentation of figures here, but they give a picture rather different from that which seems to be getting most publicity.

High rates and large differences in rates are related to some (or much?) of what we feel are inequities and give rise to pressures to create—and to use—loopholes. Political rivalry even more than normally seems likely to dominate consideration in the near term. One possibility of progress (in my view) might be the broadening of brackets, perhaps to restore the purchasing power of World War II, or pre-Korea, or even pre-Vietnam. *Vertical* discrimination would then get smaller. "Small" differences in income would not then lead to such "large" differences in tax. *Horizontal* inequity would decline in the sense that avoidance methods would produce less in relative tax differences.

Income vs. consumption as the basis for taxation

Almost without question Americans seem to accept that "income" (as somehow defined) serves as a better basis—presumably on equity as well as other grounds—for distributing the costs of government, than does consumption. The recent discussions of value added have scarcely done justice to the reasons for possibly using consumption (expenditures) as a tax base.[18]

Long-entrenched view about defects of sales taxation are not necessarily complete nor correct as applied in all situations. A mixture of considerations has misguided thinking—regressivity, burdens on low income groups—because elements not inherent to the issue of the nature of the base assume undue importance. (1) Exemptions *can* be granted under consumption taxes. (2) A true expenditure tax could have rate graduation.

Irving Fisher, just before and then during World War II, tried, in an unsympathetic environment, to make the case for consumption as being income, "what comes in." After the war, however, the reasoning got a better hearing (associated with the work of N. Kaldor) in some circles concerned with economic development. The distinction was made between taxation on the basis of income as usually conceived—what one (and one's property) put into the economic process, the worth of production, the contribution—as distinguished from what one gets, receives, takes out (consumption).

Assuming that A puts 120 into the economy (production for which he receives income) and takes out 80 (consumption) while B puts 100 in (income) and takes out 100 (consumption). C puts 10 in and takes out 110. Who on grounds of equity "should" pay more tax? Or on other grounds? There seem to me issues deserving of objective study, especially as we consider value-added taxation. Let us not decide, perhaps back-handedly on the basis of conclusions not fully applicable, that one tax potential should be foreclosed. My point, to repeat, is to avoid

[18] Dr. Norman Ture's testimony before this Committee on value added does deal with some issues which should be raised.

deciding an important question on the basis of concepts which are not necessarily conclusive.

Funds saved, not used for consumption, and funds dissaved and consumed, may appropriately be taxed more equitably (and/or with generally better economic results) under a consumption than under the familiar type of personal income tax.

PROPERTY TAXATION

In view of the current interest in property taxation, especially as related to school finance, I submit a paper on the subject.

ESTATE AND GIFT TAXATION

Some references to Federal estate and gift taxation might lead one to believe that these taxes are little more than a farce. Yet this fiscal year (1973) they will bring an estimated $4.3 billion, down somewhat from last year when a payment speed-up added to receipts. With state death and gift taxes, $5.5 billion or so in transfer taxes on owners of wealth will go to pay for government expenditures.

In spite of methods of avoidance which are presumably no secret from persons of property and their advisors, governments are collecting more than twice as much as a few years ago. Per dollar of revenue these taxes bear heavily on capital. Most academic writings with which I am familiar refer to these taxes favorably, not only as sources of revenue but also as instruments for reducing the inequalities in holdings of private property. The reasoning in support of the equalizing effects is not, so far as I know, spelled out with the completeness that ought to support major national policy.

Be that as it may, these taxes also affect the country's capital base. Private savings which would be available to finance new capital projects are used to buy the assets of estates which must be liquidated to pay death or gift tax.

One can be pretty lonesome these days in implying that the making of Federal tax policy might wisely give serious consideration to the rate of growth of private capital.

A longer study prepared some months ago is attached as part of this statement. It represents some of the results of larger projects which has not yet been completed.

The institution of inheritance becomes, in itself, directly of concern. Not all of the issues are easily defined, and few, if my personal research is typical, are likely to be "resolved." Casual impressions and off-the-cuff conclusions will not necessarily provide the considered conclusions that truly represent the best thought, and then policies, of which we are capable. Whether anything like public discussion can be conceived seems to me doubtful.[19]

In the spring of 1950, as I recall, Congress began perhaps the most thorough examination of estate and gift taxation since the 1920's. That effort, however, was one of the casualties of Korean hostilities. Changes in estate and gift taxes—and state inheritance taxes—have been made in the last 20 years, but the broad-scale analysis which is needed has not yet gotten to the forefront of Congressional attention.

To be done adequately, such an undertaking calls for a great deal of time, time which Congress has had difficulty finding. Perhaps one seems somehow disloyal to the principles of our system of government in denying that a presidential campaign offers a good forum for constructive discussion on death and gift taxation revision.

The present system certainly has defects. What are the possible alternatives? We need more examination of possible changes in the hope of clarification and agreement.

WORDS AND MEANINGS

"Reform"

"Reform" to most of us means something desirable. Labeling is easy. Proof, however, can require evidence and careful analysis. Let us not be tyrannized by words. To lump together a widely diverse group of tax features and then to call them all "reforms" which are worthy of accomplishment does not establish that the features of merit (or deficiency) appropriate to a few attach to others.

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[19] The volume by Prof. Carl Shoup received a hearing within a small group. *Federal Estate and Gift Taxes* (Washington: The Brookings Institution, 1966). Treasury studies, work of the American Law Institute, and a few articles have appeared dealing with one or another aspect of the subject.

Nor does proof that some apparently desirable results would follow a certain change necessarily indicate that on the whole the change would be progress. Or *vice versa*—one bad effect would not necessarily doom a proposal. For each major feature of Federal tax policy has several aspects. The goals are not single and simple but multiple and diverse—revenue, fairness, job expansion and improvement, simplification, and others. Interrelations can be numerous and not always evident.

"Tagging" with a term such as "reform" or "loophole" or "tax subsidy"—or citing as adequate arguments against change that "an old tax is a good tax" or "it's been that way x years" or "countries A to F do so and so"—cannot substitute for analysis if we are to make progress and avoid avoidable error.

Beliefs of commanding power influence action even when they contain a large element of error. An inferior product will not survive the competition of the market place. Ideas, however, cannot always be subjected to equivalent testing to learn their relative merits. For judging them, analysis may be man's only instrument. We have not had, say, four Federal tax systems operating at the same time, under the same conditions, with results for us to compare and use in deciding which we prefer.

Misconceptions

People, not things, bear the burdens of taxation.—*Things* do *not* bear taxes; *people* do. Some taxes reach us *indirectly* as higher prices for what we buy, others as lower incomes from our efforts and our investment. The tax may also appear as a *direct* charge on our income and wealth *after we get them*. Whatever the form, however, any tax is paid by people. And exemptions and the features being designated as "tax subsidies" affect people—the patients in hospitals or students in colleges (and their professors) that need deductible contributions, the owner of land whose price rose because of tax exemption for subsidized housing or depletion or tax treatment of timber, the homeowner as compared with the renter.

We say, for convenience, that taxes fall on business or beer or payrolls or telephone usage or real estate or sales. Whatever the first impact, however, the tax affects people: owners, consumers, or employees.

A corporation is, in one sense, a thing with its own existence. But taxes on the corporation reduce the income of those who provide the capital or raise the price of its products or cut the payments to labor and suppliers.

Voters cannot escape the problems of taxing human beings by requiring a corporation treasurer to send checks to the Treasury. Does it help—how and whom?—to try to "kid ourselves" and "fool the voter" by legislating that "the employer" must pay (and bear?) a tax of 5½% on his payroll or 48% on the company's earnings?

Hidden versus evident burdens as potential restraints on the growth of Federal spending.—In choosing to use hidden taxes, those which "conceal" the costs of government from the persons who pay, society sacrifices one instrument for helping to make better, rather than poorer, decisions on government spending. True, something can be said in favor of arrangements which free us from worry about taxes. Yet is there not more to be said for the principle of selecting taxes which are sufficiently evident to the taxpayer to enable, or force, him to relate them to the expenditures of government? Not much connection may be possible at the Federal level. But the limited scope of opportunity seems to me to enhance the importance of utilizing what might exist.

The efforts, furthered by your interest, to identify and measure special tax features—"tax expenditures" or "tax subsidies"—fall in somewhat the same class. But they call for further comment.

What does "tax expenditure" or "tax subsidy" mean? Two observations

This Committee and its staff and the Treasury know the difficulties of getting terms which adequately convey the meanings which your inquiries embrace. "Subsidy" and "tax subsidy" and "tax expenditure" apply appropriately in some cases. In other respects they may be more misleading than helpful. Two points seem worth making here. They are intended, not so much for the Committee, its staff, and the Treasury (who need not be told) as for large numbers who have had less occasion to think about the issues.

1. "Tax subsidy" or "tax expenditure," as some users of the terms almost appear to imply, is almost any dollar the tax collector does not take. "Since

government could take everything," the implication seems to be, "its decision not to take what it could is a sort of act of grace." What government does not demand is a subsidy. I caricature—but greatly? By "not taking all"—and Uncle Sam certainly could take more—does government subsidize where it leaves something? The professional economists and lawyers working on the subject do not mean anything so sweeping. The concern of the praiseworthy studies deals largely with *relative* "tax takes." Having the term "tax subsidy" to apply where taxes require less than in other situations can be helpful. Yet . . . ? Government does not, it seems to me, necessarily subsidize when it refrains from taxing where it could.

Where government taxes more in one situation than in another, perhaps the imbalance is the *higher*, rather than the lower, tax. A term such as "tax overburden" to pair with "tax subsidy" might be helpful. Throughout the studies for the Committee, the dominant assumption seems to be, almost unquestioned, that when viewing relative tax loads, the high tax alternative is somehow correct while the lower one deserves the pejorative term "subsidy." So a second point appears.

2. Who selects the norm, the basis for comparison? What is "correct and proper"—and what is the defect to be criticized and, if possible, reformed? If Congress has passed a tax law with many features, are some right and others wrong? Why? Who sets the criteria for selecting which of the many provisions enacted by Congress represent the wisdom of the democratic process and which are the excrescences of political manipulation?

Is feature X—a clearly made decision of the legislative process—the standard for judgment while provision Y—made in the same way—must be criticized? Some condemnations in discussions of tax policy are made in tones of assurance which rest, really on personal value judgments (mine included) rather than the solid basis of objectivity implied.

Is the apparently favorable tax rate on realized capital gains the "subsidy" or, rather, is this the rate which "really ought to be"? In contrast, the higher tax rate on earnings above some level may represent an abuse of legislative authority to take more from one person's dollar than from another's.

My point here involves the atmosphere of discussion—but perhaps a bit more. How can we distinguish the good from the bad? Do revenue needs make one, rather than another, element "correct"? Not necessarily. Perhaps on this score (revenue considerations) what is wrong is the "lowness" of the tax rates in the $x to $4x income brackets and not the features which keep effective rates over $10x from being higher.

Assume that approximately 20% of "taxable income" must be taken in taxes to finance the level of Federal spending. Let us say that (after allowing for personal exemptions) various special features result in some receipts being taxed at 10%, most around 20%, some at 30%, some at 50%, and some at 70%. Perhaps there is reason to apply the term "subsidy" to the 10% treatment. But if the person subject to 70% on some of his income has other receipts taxed at 35%, why designate the 35% as "tax subsidy" rather than calling the 70% "tax overburden"?

Divisiveness

Political campaigns invite emotionalism and exaggeration. Aspirants for office actively create unrealistic expectations. Taxes offer tempting opportunities. Inequalities can be cited. The inequities of extreme cases can be used to arouse passions. Some assertions of folly and unfairness are unquestionably true. Some may scarcely justify the implications drawn. Some conclusions will be downright wrong. Americans may have learned to discount "political oratory." But attitudes generated will not be entirely harmless, ephemeral byproducts of election hyperbole.

Unjustified conclusions may add to the sense of divisiveness in our society. Self-pity, anger, frustration, animosity will be enlarged perhaps among more than a tiny fraction of the public. The spirit of society will suffer, with social losses that, even though not measurable, are unfortunate. A seeker after political office may not be wrong in telling an audience that it is overtaxed—perhaps we all are. Sometimes, what will really make the adrenalin flow is word that the other fellow, one who may even have more, is not paying his fair share. Let's try to keep the facts as accurate, the conclusions as clear, as possible.

83-786—73——7

Schools, Property Taxation, and Progress: Challenges and Opportunities

(By C. Lowell Harriss*)

Bankers and other community leaders confront problems which must often seem outside the "proper" responsibilities of the job. Although almost fashionable criticisms of "business" reflect distrust and hostility (and gross misunderstanding), insistent and growing demands upon business press it to do more on many fronts. Its leaders—and its dollar contributions—are called upon to help "solve" society's problems, beyond those of production and distribution.

In many communities, for example, leaders face a 1972 version of a long-standing problem, financing education; many also face a newer one, perhaps at the doorstep—revitalizing the central city. Moreover, "reform" of property taxation may be of concern in itself. Even if not, its obvious role in paying for schools, and its perhaps less obvious tie to the growth and decline of the city, justify (compel!) more attention than merely writing a bigger check each year.

The problems range widely, reflecting the great diversity of American life. Just as the conditions of local government differ tremendously, so do opportunities. Those bankers who support a financial system of independent banks emphasize the merits of local control. The same conclusions, to perhaps even greater extent, apply to government. Travels over much of the world have yielded deep impressions of local government. We can be thankful for local authority, responsibility, and opportunity—as distinguished from centralization.

Spearheads for progress appear and press ahead. Not in every locality, by any means. But some, several, then many, localities can develop new things and then follow what seems successful. Actions can adapt to the widely diverse conditions of climate and topography, age and tradition, aspirations and hopes. Failures appear, of course, but not on a scale possible on a national level. And are they not more quickly seen and more easily reversed than if a whole country's policies must be altered?

Without romanticizing local government or blindly condemning greater reliance upon decisions from state capitols and Washington, I believe that we should strengthen the financing of local government—and in ways which will support rather than weaken the economic base. Choices which must be made (if only by default) now, will affect, for good or ill, the long-run prospects for business in the area. Issues of school finance may precipitate actions of great significance.

Paying for Education: Court Decisions

Worry about paying for education was not new when our grandfathers struggled with the problem. Although our grandchildren will have higher real incomes than we do, they will have trouble getting enough to pay for the schools they want for their children. Aspirations, especially for higher teacher salaries, cannot be expected to stabilize.

Ours will remain more a world of scarcity than of affluence. Can we keep expectations within limits appropriate to resources? We do have economic capacity to devote more to schools if, and this "if" is crucial, we can agree on the other things to curtail—outlays for health, food, housing, policing, transportation, improvement of the environment, art, recreation, retirement incomes, and so on.

Although such statements ought to be so obvious that one need not express them, community leaders know how generally public discussion prefers to ignore unpleasant realities.

The economist, and the banker or other businessmen, who insists that attention be given to the need for choosing among alternatives, may be dismissed as a hardhearted opponent of things obviously good. The lurking hope for Santa Claus, or Robin Hood, the search for ways to make the "other fellow" pay, pervades too much public discussion. It fosters irresponsibility. "State assumption of the costs of education" or "Federal revenue sharing" *can* change the kinds of taxes used and the distribution of total burdens among kinds of taxpayers. But there is one thing neither will do—reduce taxes.

An August 1971 decision by the Supreme Court of California compelled new examination of the financing of California public schools. Suits trying to establish the same principle have been filed in state after state. While the full signifi-

*C. Lowell Harriss. Professor of Economics at Columbia University, and Economic Consultant, Tax Foundation, Inc., discusses the challenges we face from rising education needs and the strains on property taxation. (The views expressed are the author's and not necessarily those of any organization with which he is associated.)

cance of what the California court started remains far from clear, a December decision by a Federal District Court (Texas) accelerated the process of reexamination. The traditional degree of reliance upon property taxation to pay for education seems to have been struck a heavy blow. The judges have said that the distribution of taxable property differs so greatly from one school district to another that the differences in funds for schools deprive some children of their rights under the equal protection clause of the Fourteenth Amendment of the U.S. Constitution.

Only time will tell what the results will be. Appeals can be expected, and the judicial process can stretch out. Meantime, state legislatures and Congress will be pressed to take account of what seems to be the spirit of these decisions. (Yet neither Uncle Sam nor the typical state legislature has uncommitted dollars to pour into larger financing of schools.)

Two aspects need to be distinguished. The first is the place of "equality" as a guide of educational policy. The second involves the role of property taxation.

EQUAL OR BETTER?

Much current discussion of education runs in terms of equality. This concern flows naturally from the words of the Fourteenth Amendment. The word "equity" also appears; but it, along with its companions, "justice" and "fairness," is hardly the same. In any case, however, is there not a more important goal? Leaders should press for better education—for all. More quantity and higher quality—for all—seem to me a more laudable objective.

Equality as a goal runs the risk of moving many down toward the middle. Yet today even the best schooling, I submit, is not so good as we ought to seek. Half the schools are above the median—by definition. Who in urging equality really wants to lower the best? As far as I know, neither the briefs submitted nor the judicial decisions explicitly discuss the possibility of forcing down school quality in some communities. The focus, I should think, would be to raise the lowest and the best—improving both. Of course, some advocates will be willing to sacrifice the better quality, especially if they believe that doing so will surely raise the poorest. But would such be fair, equitable, wise, and just?

Would it be politically feasible to "cut down" where school spending is highest? Those voters who now feel that they are paying for above-average schools in their communities may not support equalizing programs.

Improving education is consistent with moving toward equality—by emphasis on raising the least good. How? Dollars alone will not educate. The increases provided for schools by one school district after another may, or may not, be giving results as good as can reasonably be expected. Although present dollars could probably be made to yield better value, there is widespread belief that if many districts spent more on schools, the general public over a broad area would benefit from better quality and quantity of education. Who will provide these additional dollars?

Not fully the residents of the areas which now spend too little! Presumably, outsiders are expected to pay much of any increase. But as voters such outsiders do exert influence in deciding how much tax burden they will bear. Why will they vote more taxes for themselves? How far can courts force them to do so? Is there gerater willingness to pay state than local taxes for schools? Perhaps so, but the picture is less than clear.

One purpose for which many Americans will make sacrifices, for which they will subject themselves to heavy taxes, is to pay for schools for their children. Will voters do as much to finance more education if there is less of a tie to their own children? Some may, some may not.

As voters are pressed for tax dollars now, some may be reluctant to shoulder heavier burdens to pay state or national taxes for schools elsewhere. Over the years, I suspect, a significant local identification (1) of prospective benefits (2) with payment obligations, can have positive results as regards taxes designed to finance better quality.

What value system leads people to sacrifice for the welfare of children? As long as scarcity bears upon Americans as it must, even those with the best of good intentions are compelled to curb the desire to be generous.

A "foundation" level of school spending guaranteed by state finances will elicit strong support. But it will not do as much as some people wish and are able to pay for. If free to do so, some communities will exceed the general average. The country will benefit from this local freedom. The results of better schooling do extend beyond the area that pays the excess. People move. Positive "spillovers"

are no less real than the negative ones which are cited convincingly as a reason for taxing over a wide area to pay for a (rising) level of schooling for all.

Many an American in the upper middle income group is troubled by present taxes. He or she can pay still more. In many cases, more or less willingly, Americans will reduce personal consumption and saving to pay more to government. They are more likely to do so, I suggest, the more they expect their children to benefit.

Some groups supporting the court cases argue that if people in community A want to pay, say, $2 more for the education of their own children they will also have to pay $2 more for children in other parts of the state. Does this seem fair? How would it affect incentives? Is one too unrealistic and old-fashioned to believe that effort and thrift make a difference and are not unaffected by the prospects of rewards? What would be unfortunate is a condition in which the people who can pay for better education, who must be willing to support heavier taxes will oppose because too much of additional amounts seem likely to go to "others."

For the best results in financing education, a local element may need to be larger than seems consistent with the new court decisions. In any case, preserving and improving what is now "better," as contrasted with "equalizing," presents challenges to local leadership.

PROPERTY TAXATION: MORE PROGRESS, LESS POVERTY, GREATER EQUITY

The largest state-local revenue producer deserves increasing attention from community leaders. All who are seriously concerned with the health of cities should look at property tax reform as a strategic lever for improving the economic framework. Property taxation will be with us, as a major element of the economy, for as long as we can see. It not only raises almost $40 billion a year in revenue but influences the nature of local growth, or decline. In spite of complaints and "demands" for relief, none of the alternatives—(1) spending reduction, (2) higher income or consumption taxes (at local, state, or national level), or (3) greater government use of service charges—seems likely to permit more than minor, incidental, and temporary cuts in property taxation.

It has faults galore. As it exists in practice, in one place or another, it can be justly criticized by every criterion relevant for judging a tax. Yet property taxation can be made into what by most, or all criteria, is a good tax—in one respect the best.

Total yield rises rapidly, faster than one would expect from the complaints about its unresponsiveness and lack of upward revenue potential. But gross inequities exist because of poor assessment (and other reasons). High rates on buildings impair economic progress. Low rates on land discourage best use. Only a minor portion of land value increases actually get into public treasuries, rises which result from general economic change, not from the owner's actions. Such increases seem a most desirable basis for financing (local) government.

The opportunities for improvement are huge. Although some desirable changes require action by state government, and although Congress might exert pressure localities can do much on their own, in response to local leadership.

Some elements of reform seem clear. Much agreement about defects and their remedy will be found, some disagreement—and a lot of opposition. (Sometimes I feel that most Americans, at heart, hope to benefit from land speculation.) Feasible changes would materially improve our communities, our businesses, our homes, the whole economy—while distributing the costs of government more equitably.

Better administration

One need must be obvious—improve administration. Almost any adjective of opprobium would properly apply to property tax administration in more than one community. But the defects can be reduced. They should be. The methods have been formulated. Many have been tried, and tried with success. A banker need only compare tax assessments with appraisals he would accept for loan purposes to see the challenge. An unconscionable amount of poor assessment is tolerated.

Civic organization, business and professional associations, and other groups seeking to advance the public interest, should give active—and sustained—support to the reform of property tax administration. Professionally competent assessors can be made responsible and supported. Large inequities, long lags, inappropriate valuation criteria, ineffective appeals processes, favoritism and corruption, incomplete recording, and inconvenient payment requirements, these are not necessary. Every community on its own can make progress. And state govern-

ments are more likely to proceed in stimulating assessment improvement—and other phases of property tax reform—when support comes from a base of intelligent leadership.

Hardship relief

Another type of property tax improvement is removal of "equity stingers." Some states have already shown how to grant relief to older persons in need, and to others of low income, without undue revenue loss.

Unfortunately, however, most communities face an unpleasant reality: To pay for the volume of government which voters seem to approve, the tax net must spread broadly and catch small as well as large "victims." The Santa Claus dream is not a harmless indulgence of "political oratory" when it fosters a belief that the mass of homeowners (and renters) can get more dollars for schools and other governmental services without shouldering heavier taxes.

Rational recognition of economic reality: Site values as the base for more revenue, buildings for less

A more fundamental reform would build upon a basic economic principle. In an inherent economic sense "the" property tax is two widely different levies. One rests upon land as the product of nature and society. The second is the tax on buildings, machinery, and other manmade property.

A change which can be achieved would alter the incentive system so that men would then modify their private behavior in ways more conducive to community well-being. Moreover, in my view, local government revenues would be raised more equitably.

The basic idea is old—but largely untried. Mention of Henry George and his single tax proposal may evoke mixed responses. Without pretending to support the "single" aspect, the underlying principle has great merit. Reduce tax rates on buildings and machinery, substantially, and boost the rates on land values. A transition of five years, or more, could permit gradualness without delaying the major benefits unduly.

A tax on buildings (and on machinery and inventories of business) can have undesirable results. The quality and quantity of improvements suffer. The tax on land, however, can be one of the best to get funds for local government. Over the years, in fact, the tax on land value can be the most nearly painless way to raise substantial revenues—and to raise them equitably by absorbing a fraction of what is called "unearned increment." The land tax can also exert desirable nonrevenue results to improve land use.

Cost of space and land prices

The quality of life for tens of millions suffers because funds are not adequate for the facilities which governments are expected to provide. Yet, people pay "heavily" for living and working space. Their demand pulls up land prices. Bankers and builders will be aware of the high and often rising land component in the cost of housing.

Yet the increasing amounts paid for the use of land go primarily to private owners but *not* for the production of land. They get increments of value which they do not, really, earn. The issue is *not* whether the user must pay. The issue *is* how much will go to government, how much to an owner of land at purchase or by annual rental.

Population growth and rising income multiply the need for governmental services. They also create a potential source of funds for meeting some of the costs (1) without making the user of land as much the worse off, and (2) without endangering the supply of land.

LAND—LOCATION—AS A PRODUCT OF NATURE AND OF SOCIETY

Land as a productive resource resembles labor and capital in some respects but differs in others. The similarities include the fact that parcels of land, especially the desirability of location, vary greatly as do human skills and machines. An outstanding difference is the way they come into existence. Labor and capital are manmade. The quantity and quality of training, the vigor of human endeavor, the amount of machinery and structures, all these depend in part upon (1) what individuals expect to get in compensation, and (2) the payments they actually do receive. To obtain such productive capacity, society must pay. Moreover, attempts of society to take back through taxes what customers have paid for the services of capital and labor will affect the future supply.

Not so with land. Nature created it in the physical sense—and society has created much of the demand which makes some location highly desirable. The amount of land in existence will depend scarcely at all upon the dollars paid to use it. The payment, however, does make a difference in (1) what becomes available for active use within any few years, and (2) the particular use to be made of a parcel, its allocation among alternatives.

Because parcels of land do differ immensely, something to help allocate use efficiently is of utmost importance. Payments for the use of land do perform a function of outstanding significance—allocation. But payments do not, as for manmade productive capacity, also perform the function of inducing the creation of the production resources; except—and this fact is real: Costs borne by private developers (streets, drainage, etc.), and even more so the costs incurred by the community, do affect the desirability of locations.

Around large American cities, from $15,000 to $20,000 of governmental spending on streets, schools water and sewage, and other facilities will often be needed for each new dwelling. As such facilities are built, as population and incomes rise, land prices go up. The National (Douglas) Commission on Urban Problems estimated that in the 10 years to 1966 (and despite rising tax and interest rates), land prices rose by over $5,000 per family. Even a modest fraction of that $250,000 million if used for financing local government would have permitted a welcome reduction of the tax burden on buildings.

The quantity of land—space—in an area is fixed. Land cannot move. Here is the community's one resource which competitive inducements will not entice elsewhere. Tax it heavily, and it will not move to some other place, or decide to take a vacation, or leave the inventory of productive resources by going out of existence. Tax land lightly, and the favorable tax situation will not create more surface area. Rarely will the amount of space be subject to more than a little change by actions under the control of man.

The value of location, however, does depend in part upon what is done, especially by society, to make the area attractive. A tax on land will not reduce the supply of space. A tax can capture, to pay some of the costs of local government, much of the value of what the public itself has created.

Private ownership of land

Does the ethos which ties equity (economic justice) to rewards which are based on accomplishment lead to justification for rewards because of the ownership of land? Differences in payments for human services or for the use of capital can rest upon what the recipient has done; his accomplishments as valued by consumers in the market do provide a rationale for what he can get. In general, however, the owner of land has difficulty showing any comparable contribution.

The "moral" justification for reward based on creativity gets transparently thin when related to what can often be obtained as an owner of land, especially increments. The owner's contribution to production may have been nil. Or it may have been positive in getting land into better use. Some owners, however, keep land in a use below the true potential worth to the community. Land can be—and is—held in a form of low productivity waiting for community progress to raise its price.

Social costs of sprawl

Urban sprawl is familiar. Failures to make use of land would be more evident if we made more effort to stop and look. Think of the costs in extending streets and utilities farther out—and the years of life in extra travel time—as compared with more compact development.

Extensive but scattered underuse are most likely to result when owners are free from great pressure to search out the best opportunity and then to exploit it. One reason for failure to do what would seem to be in his own interest is "low" out-of-pocket cost (after income tax deductibility). Waiting for general advance of demand in the locality to bring him capital gain may be sensible for the owner even though the community incurs a largely unrecognized cost in less than the best use of land. Private ownership does not yield the benefits which are ordinarily cited as conforming with total welfare.

Underassessment of idle and underutilized land

The tax on vacant and underutilized land may now be less than if the land were valued "correctly." Current money income will be low compared with what it would be from the best use possible. If the assessors value by capitalizing

current income, then the property will be undervalued. The current figure may fall far below the possible income—what an owner could receive.

Often a significant part of what the owner expects to get—and eventually does receive—is a rise in price. Land used as a parking lot or obsolete housing or commercial use may bring only a modest amount above net operating expenses. Over a few years, however, the price of the land may go up by half, doubling, tripling, or even more. The relevant annual "income" should include the growth in value. Unfortunately, the increments from year to year may not be determinable with anything approaching precision. Yet to ignore them is to distort—and to undertax—to a most undesirable extent.

PROPERTY TAX EFFECTS ON STRUCTURES

The supply of buildings presents a striking contrast to land. Heavy taxes on buildings will reduce the quantity and quality. These taxes help to account for some of the deplorable features of our cities. There is merit in reducing the tax rate on structures.

Per unit of floor space or cubic contents the property tax on buildings hits well-constructed, high-quality, structures far more heavily than it does slums and "junk." The tax structures creates an incentive against upgrading of quality, especially in those parts of older cities with urgent needs but also with high tax rates.

Would not wise public policy encourage, not discourage better structures? The present tax discriminates in favor of buildings which produce bad neighborhood effects. The owner of a dilapidated structure will be freer from economic pressure to replace it with something better if his assessment goes down because the building gets worse. Any individual or business wishing to shift to use of a higher quality structure must also pay more, often much more, toward the costs of government—and not for more (or higher quality) services.

Cities that urgently need to replace obsolete and decayed buildings rely heavily on a tax which creates a [substantial] bias against replacement.

The quality of building space available for work and living will depend greatly upon the maintenance of the stock of older buildings. Undermaintenance forms one way by which an owner can reduce his net investment in a building and the annual tax. His actions in letting a building run down will hurt others, the larger neighborhood. Good maintenance, however, can be combined with improvements which have "spill over" benefits for a broader neighborhood.

Property taxation has some influence—adverse—on maintenance. The tax reduces the net return and thus the attractiveness of putting more dollars into such properties. With or without good reason, the owner may fear that a "repair and maintenance" job having visible results will bring an assessment increase.

Effect on price: Building and land

The property tax on buildings adds to the cost of supplying them to the price which must be charged. Analysts of the shifting and incidence of property taxation have not yet come to agreement on the extent to which the portion falling on buildings eventually rests upon suppliers of capital as against consumers using the buildings or the things they help to produce.

Unquestionably, however, in some localities this tax makes for higher cost of housing. In using the building, whether for business or private residential purposes, a substantial cost-of-government element must be included. In this way the tax will reduce the amount demanded. One result is a hidden, or what economists call an "excess," burden. For example, within considerable limits, the cost per cubic foot of construction declines as the size of the house, apartment, office, or other unit increases. The tax on structures creates pressure for building smaller rooms, etc., with less of what we really want in living room and amenities per unit of labor and materials used in construction. By indirectly altering the type of construction, the tax on buildings thus deprives the occupant of potential benefits for which government treasuries get no dollars.

The tax on land, however, makes for a lower price (beyond the effects of inducing owners to reduce speculative withholding and putting more on the market). If tax on land is increased, the amount remaining for the owner drops. The price a buyer will pay goes down. Government takes more. The user pays no less for each year's use, but government through taxes preempts more.

In this way property taxes on land are "capitalized." They reduce the price which a buyer will pay. Thereafter, the user (buyer) of the land turns over, in

effect, more of the yield to government. But the person who has purchased after the tax became effective does not suffer from it. The owner of land at the time "paid" the tax increase in perpetuity. In practice, what he fails to get may be only a portion of a price rise due to social change.

Other effects of high taxes on improvements

High tax rates on buildings (and little reliance on land value) reenforce incentives for creating "islands" of relatively low tax rates. One defect of property taxation for school finance which the court decisions have noted is the inequality of tax base per child. A large industrial or utility or commercial establishment may serve a public residing in a far more extensive area. The tax, we can assume, is borne largely by consumers or investors in the broader area. A few localities in a metropolitan area will have tax resources which are above average in relation to service obligations. With lower tax rates they can have above average quality of services, attracting still more investment. This result comes predominantly from the inequality of tax base in buildings, not land.

Some communities use zoning power to exclude types of property associated with high governmental expense—the high-density housing which requires heavy school costs. Other parts of the metropolitan area, however, must pay higher taxes; elements of a vicious circle gain strength.

People who wish to escape the urban center must leapfrog over the "islands." Such land use imposes higher costs than if population were spread more in accord with factors free from the influence of tax on buildings. Some disadvantages were noted earlier in discussing "sprawl."

A note on distribution of burden and (alleged) regressivity

Who actually bears the burden of property taxation? Neither the theoretical analysis nor the empirical evidence is as clear as we should like. A part of the tax on commercial, utility, industrial, and housing structures can be assumed to fall on consumers more or less in proportion to spending. This part, then, has some of the repressive elements which is often cited in condemning the tax. But despite frequent implied assertions to the contrary, a part probably remains on suppliers of capital; this will be more progressive than proportional (and not regressive). The considerable portion which falls on land, much of which was capitalized in the past, is hard to place in a meaningful sense—except to say that past and present landowners are generally "not poor." The distribution of this burden will be decidedly more progressive than regressive.

In short, although families with "low" incomes or consumption do bear property tax, persons who own, directly and indirectly, "large" amounts of property must carry burdens which are "heavy." Any reduction in tax rates would confer windfalls according to ownership—and property ownership is more concentrated than that of income.

Pressure to reexamine the financing of education should not, in my judgment, lead to abandonment of a large enough local element to permit meaningful efforts by communities which are able and willing to exceed the average. Property taxation can provide an instrument for doing so. It can also provide a source of funds for states which decide to pay for a bigger portion of school costs.

In any case, however, reform of property taxation should have a high place on the agenda for public action.

Estate Tax Reform Proposals: Economic Effects of Death, Taxation and Capital Supply

(By C. Lowell Harriss*)

Defects in the system of taxing estates and gifts were discussed, and ably so, by Mr. Kurtz and Professor Surrey as they made a case for specific changes.[1]

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[1] Kurtz and Surrey, "Reform of Death and Gift Taxes: The 1969 Treasury Proposals, the Criticisms, and a Rebuttal," 70 *Columbia Law Review* 1365–1401 (1970). For the proposals see U.S. Treasury Department, *Tax Reform Studies and Proposals*, a Joint Publication of the Committee on Ways and Means . . . and Committee on Finance, U.S. Congress, Feb. 1969. Part 3. Available from Supt. of Documents, U.S. Government Printing Office, 1969. The Committee on Ways and Means, *Hearings on Tax Reform* . . . 1969 include some testimony. See also D. Westfall, "Revitalizing the Federal Estate and Gift Taxes," 83 *Harvard Law Review*, (1970).

Their discussion could not cover all aspects of what is inherently a difficult subject. Any scholarly analysis of these taxes and of state death taxes runs into baffling obstacles. And when the discussion expands to embrace the issue of capital gains and losses unrealized before death, the variables to be considered grow in number and complexity. The present article deals chiefly with an economic aspect not included in the Kurtz-Surrey paper.

Citing one fact will help to set the stage. Death and gift tax revenues, including those going to states, now yield over $5.5 billion a year. This amount exceeds 7% of all net saving, including corporate profit retention and pension fund growth.

BACKGROUND AND IMPORTANCE

Treasury staffs over many years have explored various problems and possible revisions of the laws. Extensive studies under the direction of Prof. Carl Shoup of Columbia University[2] and a large project headed by Prof. Casner of Harvard University and sponsored by the American Law Institute[3] examined in detail possible ways of dealing with major issues. Each made some specific recommendations. Such extensive analysis may be unprecedented in the history of American taxation.[4]

In view of the complexity of the issues, no public opinion resting on the "common man's" intuition and good sense could possibly lay claim to competence. Yet the subject has no small importance for the general public. The amount of wealth potentially affected runs into a large multiple of the $25 billion or so a year shown on Federal estate tax returns—a total of property of great concern to the country as a whole.[5] The way this wealth is used, *i.e.*, the form the investments take—and the amount remaining after tax—will have significance to workers and consumers who have not the remotest awareness of any connection between their economic welfare and the taxes on (large) estates. Over the years, death taxes do affect both the amount of wealth and the way it is invested.[6]

Owners of property and their heirs, of course, have direct concern about the structure of the taxes. When each dollar of difference in taxable estate at $100,000 means 30 cents of tax, even families of rather modest means can be affected, perhaps by more than they realize. At $1 million the Federal government begins to take almost two-fifths of each additional taxed dollar; for amounts over $2 million, Uncle Sam is only one cent short of being an equal partner.

SEARCH FOR EQUITY IN TAX BURDEN

Many factors influence the dollar amount that will actually be subject to estate or gift taxation. Several elements of considerable potential are under the control of the taxpayer. Some depend upon other forces, such as the level of asset prices at the time of taxable transfer and the changing composition of the family group. When *large amounts* of tax depend upon actions over which the taxpayer has control—and upon others which may be more or less accidental or random—inequity seems likely.[7]

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[2] Carl S. Shoup, *Federal Estate and Gift Taxes* (1966). This volume presents, among other things, analyses of special and detailed tabulations of data from estate tax returns filed in 1957 and 1959. Unique information about the use of trusts and lifetime gifts was drawn from the examination in depth of a carefully selected sample of tax returns.

[3] American Law Institute, *Federal Estate and Gift Taxation* (1969).

[4] The *present* estate and gift tax laws certainly cannot lay claim to any such detailed prior study of possible alternatives. See C. Lowell Harriss, *Gift Taxation in the United States* (1940) for some historical material. The survey includes background review of the 1930's when much of the present structure was enacted or became firmly established. Adoption of the marital deduction in 1948, a major change, was preceded by limited study.

[5] The last year for which detailed statistics have been published covered estate tax returns filed in 1966. They showed gross estates of $21 billion. Since revenues have increased greatly in subsequent years, one can be certain that the gross amount of property, as well as that taxable, has risen considerably. The figure in the text is probably on the low side.

[6] Among the effects of death taxes on the way or forms in which property is invested, one result is undeniable—pressure to keep the estate more liquid than would be needed if the tax were lower. See C. Lowell Harriss, "Economic Effects of Estate and Gift Taxation," U.S. Congress, Joint Committee on the Economic Report. *Federal Tax Policy for Economic Growth and Stability* (1955), pp. 855–864 at pp. 860–862.

[7] C. Lowell Harriss, "Sources of Injustice in Death Taxation," *National Tax Journal*, 289–308 (1954). Quoting from a recent article by the present author: . . . "By all the concepts of tax equity that I can think of—some quite different from others—estate and gift taxes as they now exist fall short of reasonable standards of justice and fairness. Burdens are sometimes too great relative to others. But in which cases? By how much? Why?

"The fact that the major features of the system have existed for a long time does not mean that they are the best possible. Estate planners who have gained familiarity with

The proposals which were advanced by the Treasury and supported by Mr. Kurtz and Professor Surrey rest upon concepts of equity which deserve much respect. A search for equity dominates the proposed programs.[8] The total can be supported as being one of integrated and internally consistent elements. In view of the importance which properly attaches to equity as a goal in tax policy, the proposals designed with this consideration in mind will command sympathetic attention. Critics of the recommendations, several of whom are cited by Kurtz and Surrey, seem less concerned over some of the features leading to (alleged) inequity than would the present author.

Nevertheless, no one set of proposals, no matter how sophisticated, can meet all defensible criteria of equity in death taxation. Conflicts must inevitably arise as one takes account of various standards, properly respected standards, of what is fair. In sharing the cost of government on the basis of transfers at death, or by gift, what, really, constitutes fairness, equity, and justice? Ambiguities and inconsistencies will arise in the meaning of equity as tied to income, consumption, or property taxes. But the difficulties in death taxation are greater.

Tax equity involves personal situations, effects on people. In evaluating the results of any tax as regards fairness, problems of tax shifting and incidence present greater or lesser troubles. But larger than normal uncertainties arise in death taxation. One set of problems grows out of a basic doubt about the objective—is the decendent or are the heirs, the one(s) intended and desired (by the policymaker or voter) as the person(s) to be burdened? Without an understanding of the goal in this respect, equity as a personal matter remains confused. Complicating the problem is the fact that the owner has from large to limited power to determine who his heirs will be and hence the tax on each. More complications on equity grounds arise because a decedent (donor) can, to some degree, govern the total tax on his transfers.[9]

The lawmaker cannot really determine who will bear the tax on estates and gifts in the meaningful sense that in framing an income tax or a sales tax he can base decisions on reasonably clear notions of incidence.

HORIZONTAL EQUITY

One of the respected concepts of equity in taxation, *horizontal equity*, seeks to burden equally those who are in essentially similar positions (as regards the elements which are considered relevant for sharing the cost of government). In this sense, "equity" has some meaningful relation to "equality." Fairness and justice result when equals are taxed equally.

This objective plays a large role in the concepts underlying the Treasury Proposals. The plans are presented by the Treasury (early 1969) do not seek to alter the total tax paid by decedents (heirs) as a group. The same revenue total would be collected. But the total would be distributed on a basis which conforms more closely to concepts of fairness (as they relate to conditions which are relevant to bearing the expense of government). One can applaud the motivation, the efforts, and the results as far as ths aspect of equity is concerned.[10]

VERTICAL EQUITY

Another concept, *vertical* equity, seeks to allocate tax among people so that some pay more than others according to criteria which are appropriate. The differences in personal conditions, not the similarities (as with horizontal equity), become matters of paramount concern. Death taxes represent outstanding examples of levies which do impose very widely differing burdens. What criteria

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the present system may feel differently. Perhaps somewhat unconsciously, they may believe that it is about the one which "ought" to continue. A careful survey, however, would leave no doubt that many imperfections remain, not the least, perhaps, being the height of taxes in some cases." C. Lowell Harriss, "Estate Taxation and Needs for Capital," 110 *Trusts and Estates* 538. For brief examination of issues involving the concepts of equity see C. Lowell Harriss, "Tax Equity: A 1968 Look," *Proceedings . . . National Tax Association*, 1968, pp. 168–181.

[8] The proposals were prepared in the U.S. Treasury while Professor Surrey was Assistant Secretary for Tax Policy. They were not forwarded to Congress until after Treasury leadership shifted with the transfer of the Presidency in January, 1969. The new Administration neither endorsed nor disavowed the plan, in general or as regards the particular elements.

[9] See Shoup, *op. cit.*, Ch. I and VIII.

[10] The total "package" includes a new treatment of capital gains and losses unrealized before death. Only appreciation after December 31, 1969, would be subject to the new tax features proposed. Such treatment would be much less sweeping than some advanced on other occasions.

"should" govern or determine *how much* difference in burden—and *why?* This aspect of equity emphasizes inequality. The issues necessarily involved are endlessly baffling.

The authors of the proposals have avoided much of the quagmire of direct analysis and of explicit debate on this aspect. But they have "acted" on vertical inequality. They have devised a set of changes which would broaden the tax base and reduce the rates where they now bear most heavily. This general plan for achieving more horizontal equity would also, by reasonable (but admittedly debatable) criteria, achieve more vertical equity.

Families *are* unequal. Always, then, there will be the question of how much more one group should pay than another when the two do clearly differ—in respects that are rationally related to the purposes at hand, in this case the transfer of property, generally from one generation to another as a basis for paying for government. A not unfamiliar human tendency can push for higher tax burdens on the other fellow. People who are convinced of their own goodwill and good intentions have been known to press for heavy, or heavier, taxation at death. Citing motives of an admirable sort, they feel that the general public will benefit from such policies. They may believe that such a tax policy is fair and equitable. Who can prove them right or wrong?[11] Political appeal can be decidedly one-sided. The number of persons or families who would be forced to pay more would be small; the number who might feel somehow benefited could be many times as large. Vertical equity certainly gets mixed with issues of political appeal in ways that are hard to balance with other considerations.

ADVANCE PLANS SUBJECT TO ALTERATION IN THE POLITICAL PROCESS

Partly because of political factors, matters of death tax revision are likely to involve greater complexity than can be encompassed by any program prepared by a single group. A consistent plan going to Congress will be discussed in a context inviting the examination of more issues than perhaps expected. The final results may be quite different.

The Treasury proposals would not appreciably alter the total revenue. But issues of revenue change would certainly be raised. Advocates of greater revenue could support features which would curtail opportunities for avoidance but oppose reduction of tax rates as proposed by the Treasury. Why not keep the present rates? They have been in effect for 30 years—but not, it could be argued, fully effective. Total revenue could be increased by bringing more property within the scope of present tax rates. Such a line of argument might have much political appeal.

Moreover, capital gains unrealized before death could seem to offer an inviting opportunity for adding to revenue. (More than one group could propose uses for more revenue dollars.) This added burden at death might be presented as an income tax rather than a boost in the estate tax. The Treasury study presents a case for modifying the system which has long prevailed but limited to future appreciation.[12] Advocates of more revenue could perhaps argue, "If a little is good, would not more be better?" Why not impose this new tax without moderating estate tax rates?[13]

Whatever may seem persuasive on grounds of fairness, other aspects should also command attention. Equity, by any definition which is likely to be accepted,

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[11] In academic circles and among economists who write about tax policy, there would probably be unquestioning belief that higher taxation of estates and inheritances is fair. When a person holding such a view is pressed to give reasons supporting his position on the equity conclusion, he may have difficulty in formulating a case which will be convincing. Citing "ability to pay," he may feel that he has an answer. Yet that concept turns out to be surprisingly difficult to define in terms that are operational, *i.e.*, as a practical guide to actual decisions, or that are intellectually satisfying as a matter of principle. See Walter J. Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation* (1953). The bulk of the volume deals with taxation of income rather more than with estate, inheritance, and gift taxation. But the analysis of issues has general relevance to any tax policy involving differences in tax rates.

[12] The Nixon Administration has not endorsed the views of its predecessors on this issue. For some statistical data see Kul B. Bhatia, "Accrued Capital Gains, Personal Income and Saving in the United States, 1948–1964." 16th *Review of Income and Wealth* (1970), pp. 363–378.

[13] By this line of reasoning an alternative possibility might deserve consideration: if capital gains tax has been paid on property before death, then some exemption from death tax of what remains would be a way to reduce the inequality of treatment when appreciation unrealized before death is subject to estate tax as is now the case. This conceivable alternative to the Treasury proposal may indicate that a defect on equity grounds can be dealt with in more than one way.

even intuitively, does *not* cover the whole range of considerations involved in tax policy. Taxes have effects other than separating the taxpayer from dollars to be spent by government. Before turning to the "nonequity" aspects in the context of death taxation, another topic deserves brief attention.

MORE SPENDING?

Some defense of higher total death tax revenues would come from desires for bigger governmental spending. The pressure for greater Federal (or state or local) spending seems to grow along with concurrent complaints about the disappointing results from increases in expenditures. For more than a generation it has been customary when a problem is perceived to propose that "the" approach to "solution" lies in more governmental spending.

The responses to date might seem to outreach the highest expectations of anyone who, a decade or two ago had, sought funds through government to deal with difficult problems. Total spending, per capita in dollars of constant purchasing power (1970 dollars) for nondefense purposes—note (1), per person; (2) the allowance for price inflation; and (3) the exclusion of defense—rose from $660 in 1960 to $1,180 in 1970 (almost 80%). How much of society is better as a result of the rise of spending—schools, health, highways, welfare, space exploration policing? Without meaning to imply that nothing is better, for such would be irresponsible, one can nevertheless question the efficiency and productivity of governmental approaches to many problems.

Studies of the results of government performance do not support any general confidence that expansion of governmental participation (spending *plus* taxes) would improve on the total accomplishment of the economy. One reason for apparent dissatisfaction, a reason perhaps inadequately recognized, stems from the taxes needed to pay the costs. Such taxes reduce the ability of people to provide for themselves.

More revenue could be obtained at death (including the yield of a "new" tax on capital gains). Political pressures to do so would not be eliminated by omission from a Treasury package. Perhaps the revenue would be used to pay for worthy governmental spending programs. The argument would be made. Advocates might imply that such could be done by merely hitting the rich without adverse effects on other Americans. This would be a position consistent with much that may "come naturally" to some who seek to change social policy. The Treasury did *not* take such an irresponsible attitude. But might not others find the temptation strong? *Counterbudget* does take such a stance.[14]

The truth about the effects of taxes does not always conform to casual impression. An example, largely overlooked, grows out of the fact that death taxes reduce capital, probably almost dollar for dollar. And such capital consumption has effects which are easily overlooked. This element deserves explicit attention in reforming tax policy. Once the issue of death taxation is being considered, pressure to increase burdens would doubtless arise. If so, the country's stock of capital would also be directly, but not obviously, involved.

REDUCING CAPITAL

In saying that these taxes reduce capital—by $5.5 billion or so a year—an economist does not mean that the taxes destroy machinery or industrial buildings. Nor does such real productive capacity go from private to governmental ownership (and operation) when the estate of the owner must get rid of assets to pay tax. When an executor sells shares of A.T. and T. or Sears Roebuck, the corporation's assets, *i.e.*, the company's productive machinery, will not be depleted even though the former shareholders' dollars go to the Treasury. What does happen is that the dollars used to buy these shares are not available to purchase other assets. Funds which could go into the expansion and improvement of productive capacity (including housing) are used to purchase the ownership (or debt) of existing capital goods.

Businesses or others seeking new capital find that the total of funds is smaller than it would be if death taxes were not siphoning off a portion of all net private

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[14] See The National Urban Coalition, *Counterbudget* (1971), p. 318. As part of the agenda for raising large additional revenues: "5. Recoup more of the wealth passed between generations by setting a lifetime exemption limit of $50,000 on recipients of estate and gift taxes [*sic.*, Presumably the authors advocate an accessions type of tax. Author.] and by taxing all appreciation of assets, realized or not, upon transfer." This chapter is not signed. The volume shows Robert S. Benson and Harold Wolman as editors with a foreword by Sol M. Linowitz. The index to the volume shows no references to "capital" or "investment."

saving. Ours is a complex economy with many flows of funds, with interrelationships of great variety. We may not be able to pinpoint one element, such as liquidation for death taxes, and say with assured confidence that any particular sectors or industries or elements are specifically affected to some measurable amount. For the economy as a whole, however, one basic fact can stand as a point around which tax decisions can be made: The funds going to pay death taxes are not available to pay for new capital formation as they would be, for the most part, if left in private hands.

At one time debates about death taxes did lay considerable stress on the capital-destruction aspect.[15] For several decades, however, professional literature was largely ignored these points, or seemingly dismissed them as unworthy of serious attention. Several reasons help to explain this shift of view. (1) A misstatement of the case, implying that real capital goods (buildings) as well as financial capital would be reduced, could easily be proved to be wrong. Such disproof then cast discredit on the element that is true.

(2) In the 1930's "oversaving" seemed to be a source of difficulty for the economy. "Stagnationist" economists felt that at high levels of national income people would try to save more than businesses would want to spend on new investment goods. Funds would thus be taken out of the flow of the income stream. If so, taxes to absorb some of the saving would actually be desirable because government spending would move the dollars. Some of the attitudes of the 1930's which determined the present rate structure of death taxes grew out of this theory and its essential assumption that demand for new capital goods would lag. Professional economists who got their training in the 1930's or for quite a period after World War II were likely to be more steeped in these views than they realized.

(3) A somewhat different feeling seems to permeate the attitudes of many economists and others who talk and write about public policy, including tax policy. There is a belief that, somehow, the society will generate "enough" new saving when the economy prospers. Experience may seem to confirm such a comforting attitude. Since the economy does adjust to whatever savings are available, the effects of inadequacy are not dramatically evident as such. Rather, we hear of high interest rates, housing shortages, "misallocation" of capital and the need to "rearrange priorities," inadequate financing for minority business, state-local borrowing postponed.

(4) Since high estate taxes fall on accumulations of property that exceed those which most of us can expect, and since a strain of egalitarinism runs prominently through much writing on tax policy, one theme can be predicted correctly. The value judgments of many writers will favor the reduction of large fortunes, and the use of the funds to pay for government services. Such a conclusion, however, does not take account of the effects on capital growth and the results which follow.

CAPITAL AS A MEANS OF PRODUCTION AND SOURCE OF INCOME

A capital asset will yield services over time. A house, for example, provides shelter—the values of occupancy—for a period of years. The human effort and the materials which go into production of food, clothing, the daily newspaper, and other nondurable or semidurable items—or such services as musical rendition, a golf match, or legal advice—yield their benefits for rather short periods. Capital goods serve much longer. To some extent, as with housing or a hospital, the capital item may produce more or less directly for the consumer. In other cases the capital goods help in the creation of consumer goods or more capital facilities—steel plants, chemical factories, machine tools.

Much of a society's ability to produce depends upon its stock of capital goods. Much of the difference between our levels of living and those of our grandparents, and those of other parts of the world, depend upon more and better capital facilities. They are built up, used worn down, replenished, replaced, and modernized, as part of the activities of the economy. Net additions to the stock of capital consist of output which is not consumed at about the same time as it is produced.

Each year's growth of capital consists of production which exceeds consumption (machines, generators, planes, houses, etc., that are created and continue to exist). A society may make rather small net additions, or "large" ones. The economy produces 100, consumes 90, and has 10 as an addition to its nonhuman wealth. This 10 in a real sense is saving. This elementary relation of consump-

[15] See W. J. Shultz and C. Lowell Harriss, *American Public Finance*, 8th ed. (1965), Ch. XX.

tion to capital expansion is so taken for granted that we give it no attention.[16] A high consumption economy, such as ours, draws upon the fruits of past savings as the machines built then produce for consumption later. The capital accumulation of the past gives us a better level of living than if our predecessors had saved less.

The consumption can be so high that growth of capital slows. High consumption can be in personal life. On balance, over the whole society rather little income (after tax) may be saved. Some of the high consumption may be through government—in the "public" sector; decisions for "large" government expenditures can be (generally they are) for largely current services (or for transfers, such as welfare aid) which have little benefit continuing into the future. The spending leads to borrowing and high taxes. The money paid in taxes cannot be used for personal savings. Funds which are used to buy new government bonds (Federal, state, or local) are not available for financing housing or business expansion.[17] Perhaps the choices of large governmental outlays are wise by reasonable standards. Perhaps not. In any case, the resources used are not available for private capital formation.

Taxes such as those on transfers at death or by gift fall heavily per dollar of revenue on capital. They effect—adversely—those aspects of life which depend on capital. So would an added death tax on capital appreciation.

Capital plays more than one important role. Some are not adequately appreciated.

ROLE OF CAPITAL: TECHNOLOGICAL PROGRESS

The speed of technological progress in actually benefiting mankind depends heavily upon new capital. Scientific advance plays a crucial role in economic progress, in raising levels of living for more and more millions each year. Much of the contribution of better technology becomes available through new facilities, *i.e.*, it appears in usable form, or is transmitted in ways that bring value in actual use, in new machinery, and new methods. New products and services often require productive capacity different from that in existence.[18]

Quality improvement and *cost reduction* depend heavily upon research, investment, and technological advance in many forms. New types of capital equipment embody the fruits of scientific research, many of which cannot otherwise be put to use. Capital formation, therefore, brings benefits which are greater than the addition of *more* equipment. Today's additions tend to be of the *best* quality, the most advanced types. Savings invested in new capital facilities, therefore, yield a "technologcal dividend." Society gets benefits which are over and above the "more" of quantity.

Much of man's hope for true progress in new products, in cost-reducing methods, in antipollution and other environmental improvement, in many of the varied aspects of life, all these relate closely to the advance of science. While in the laboratory or on the drawing board, these are not worth much. Actual application for the advantage of mankind requires more. Businesses need capital funds to

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[16] In 1961 and 1962 the Treasury pressed for an investment tax credit as an aid to expansion and modernization of the economy's stock of machinery and equipment. During the debates little or nothing was said explicitly to the effect that net additions to the economy's stock of capital would require saving. An availability of funds (resources) was implicitly assumed. When an economy has substantial unutilized productive capacity, as ours did in 1961, one part of the economy can expand without much deprivation of others. Year in and year out, however, the use of otherwise idle productive capacity to create new capital goods has narrow limits. Use of the banking system to create credit (money) to finance the installation of machinery or the construction of housing will tend to be inflationary.

[17] Some government spending does go for expansion which by any reasonable definition qualifies as "capital." A society must have types of infrastructure which would not be provided by businesses in the market economy. And some government expenditure goes for what is now termed, correctly, investment in human capital. The amount of what is properly designated as net capital investment (outlays above an allowance for depreciation) do probably exceed the revenues from death taxation. The author would not urge any dogmatic position "in general" about the relative magnitudes—except to emphasize that reduction of private capital through taxation by no means assures that government use of funds will be as good as private use. Government cannot be ruled out entirely as a net "accumulator" of capital. Secretary of the Treasury Andrew W. Mellon succeeded in getting budget surpluses year after year in the 1920's. The funds received by bondholders as Federal debt was repaid could then be raised to finance private investment. In the 1970's, however, budget surpluses seem unlikely except by accident, and temporarily. Pressures to spend are almost overpowering.

[18] Fears that automation destroys more jobs than it creates have caused unnecessary worry. For discussion of the economic issues see C. Lowell Harriss, *The American Economy*, 6th ed., 1968, especially Ch. 39. See Simon Kuznets, *Capital in the American Economy . . .* (1961) for an exhaustive study of the historical record.

buy the new and most advanced equipment which is required for utilizing the potentials of new technological advance.[19]

JOBS, EARNINGS, AND CAPITAL

Businesses create jobs. The focus on governmental policy and its effects on employment can be quite misleading, especially as regards the longer run. Useful employment lies predominantly in the private sector. (And the production of the private economy generates most of the tax revenues which enable Federal, state and local governments to pay their employees.)

Jobs exist because workers are expected to produce goods and services which can be sold for more than the cost of wages and other inputs which the employer must buy. Two other elementary facts: (1) What a person does produce will depend upon his own skills and effort. (2) And also upon the "tools" he has to work with.

Most of us expect incomes which can be produced only with the help of capital goods, often of many types. A doctor's office and his share of a hospital; factories and theaters and mines and refineries; retail establishments with inventory as well as the building; the cranes of construction and the trucks and trailers of transportation; the computers of banks, airlines, insurance companies, hotels; the law office in a building which cost thousands per room and a library and office machines; jobs in such settings can pay well only when capital equipment, usualy worth many thousands of dollars, supports the worker. How many men or women *on their own* would turn out goods and services salable for enough to leave the worker, say, the $9,000 which (fringes included) is rather common today?

Without for a moment denying the central role in determining income of personal skill and training, as well as the intensity of effort and the hours worked, one must emphasize that capital equipment also plays a part of decisive importance.

Fortune's 1971 survey of the 500 largest industrial corporations found that the median of assets per employee was $24,100. For the next 500 the figure was $21,600.[20] The 1,000 companies surveyed employ a sizable fraction of the labor force. If we treat the Bell System as a unit, it is the largest nongovernmental employer; its capital (net assets) per employee would be over $60,000. Such asset figures rest on historical cost, prices at the time facilities were acquired; they probably reflect only a modest portion of the inflation of the last few years. At today's prices of factories, machinery, and goods in process (inventory), the dollar amounts would be larger. And in many cases something should be added for rented property because the company's operations make use of capital goods, a retail store building or a computer, supplied by others on a rental basis.

The great bulk of American employment lies in business organizations which can succeed in satisfying customers only if labor and capital are combined in proportions which probably involve over, more often than under, $20,000 of assets per worker (1971 prices).

In each of the next few years a *net* increase in the labor force of around 1,500,000 must be equipped. Capital for these jobs—the expansion of working population—cannot come from printing-press dollars or easy expansion of bank loans. The funds must come from saving.

Another fact of life rules out any easy and automatic "solution." Few young people can themselves supply the capital which they implicity expect to have available for their jobs. How many parents, having perhaps financed children

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[19] Depreciation funds can finance some technological advance in replacing old with new. At best, unfortunately, this result is slow. For one thing, the new equipment will often require more dollars than the old—because of greater complexity. And when inflation persists, depreciation based on historical cost may fall seriously behind what is needed to maintain productive capacity. At any time, especially during recession (as in 1971), an apparently large amount of capital equipment will be underutilized. One of numerous reasons is that the quality of the facilities is not high enough to permit their operation at the prevailing wage rate and with product demand at the level expected. As wage rates go up, employment will go down (other things being the same). Over the years, one preventive is the improvement of capital facilities to keep total cost from rising as much as wage rates. If such a result is achieved, product prices can be kept from going up by enough seriously to reduce the quantity sold to consumers.

[20] Figures such as those cited here are approximate. Interpretation presents more problems than can be discussed. The general orders of magnitude are sufficiently revealing to make the central point. Good jobs typically require substantial amounts of capital in place before the worker can be hired. Few professors probably have any conception of the total investment in laboratories, libraries, offices, computers, and other facilities needed to support university or college employment.

through high school or college, can then supply the $15,000 to $25,000 of capital needed for a (good) job? Rather few.

The additions to the capital base which make the jobs possible, as a rule, and for the most part, must come from others than the young people and their families. The funds must come in advance of employment. Jobs good enough to support modern earnings expectations require "large" investments. Does the common man, does the young person seeking work, have any better friends than the people who provide the capital that makes a job possible?

These "friends of the worker" do not think of themselves in that way because they "finance" production. The economy does not so designate them. Such personalization is not needed.[21] But the reality of capital is essential for the growth of employment. And capital will not come from the wishing for it. What will make it available? First, there must be income after tax which permits savings—by corporations and families. There must be willingness as well as ability to save. Then, as savings are made, incentives must be sufficient to induce investment in real productive capacity. The expectations of interest, dividends, capital gains, or other benefits, must be high enough, after tax, to make the proposition worthwhile. When capital and labor are as productive as we see today, employees can get the major share of the very large total output; government can take a hefty portion; the remainder will generally give the suppliers of capital enough return to make for a progressive economy.

One aspect of this progress highlights another portion of the need for *additional* capital in business. This aspect relates to death taxation more than is generally recognized. Over and above the amounts which are needed to equip the growth of the labor force, additions to capital are required to help workers, and their wives and children, realize their *expectations of rising income.* Many Americans want their incomes to rise from year to year—real income in the sense of more goods and services.

For the economy as a whole, a rise in *real* income per person comes from greater output of capital and labor, more per worker. The usual reference is to productivity per man or manhour, though the better references are to total productive capacity (labor and capital). Productivity goes up as a result of advancing technology, the accumulation of skills on the job, better management, rising average educational attainment, transfer of workers from lower to higher productivity jobs, and other factors. On the other hand, more holidays and longer vacations, along with other increases in leisure reduce the manhours worked productively per person. Any sizable increase in production, and in real earnings per worker will necessitate additional capital per job.[22]

Companies improve their nonhuman productive capacity by adding more facilities and better ones. They install types which embody advances in science and technology.[23] How much new capital, on the average, is needed to enable a company to pay a worker (fringes included) something in the range of what he wants as additions, whether $200 or $300 or $400 more a year? From company to company, from industry to industry, conditions differ greatly: no single capital/output figure will be accepted as fully satisfactory. Nevertheless,

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[21] Does the term "capitalist" carry overtones which, on balance, are more favorable than unfavorable? It is not only the hand-out "literature" found occasionally around college campuses that refers disparagingly to "capitalists" and "capitalism."

[22] Customary references to manhour productivity fail to point out that some, perhaps most, of the improvement recorded comes from better capital facilities rather more than from better work by the person on the job. Separation of the results attributable to labor from those due to capital cannot be fully satisfactory with even the best of measurement methods available. What is important for the analysis in the text is the fact that, in general, more and better equipment is ordinarily essential for productivity increase on any scale of significance.

[23] Advance of technology accounts for a considerable portion of the total increase in output per unit of input. Denison estimated for 1950 to 1962 that "advances in knowledge" were the source of 0.76 percent a year rise in national income. Though subject to a large margin of error, this estimate accounts for well *over half of the total* sources of increase in output per unit of input. Reducing by 1.6 years the average lag between the average practice and the best known would contribute 0.1 points a year to the growth rate. "In the world's most advanced, efficient, and diversified economy, this would seem to me to be a very large change." E. F. Denison, *Why Growth Rates Differ: Postwar Experience in Nine Countries* (1967) at p. 282. Most of the growth of national income (1.95 out of 3.32 percentage points a year) came from increases in labor and capital inputs. (p. 192). Net increase in labor inputs (education chiefly) accounted for 0.22 percentage point a year in the rise of national income *per person employed;* increase in capital was almost 3 times as important—0.60 percentage point per year. Advancing knowledge was still greater. (p. 194).

at current prices of machinery, $2 or more of added investment will frequently be needed per $1 of added income per year for the employee.

In any case, however, the total annual capital requirement for raising the real earnings of a nongovernmental labor force of nearly 70,000,000—to raise earnings more or less as workers expect—this total will come to a huge amount. *Each year*. This is economic progress. Much *is* possible. Yet we do fall short.

One reason that aspirations have not been met more fully—one reason that manhour productivity and real earnings have not gone up as fast as money payments and expectations—this reason, is that the capital base has lagged. The new types of equipment have not been added fast enough, and extensively enough through all industry, to "validate" wage rate increases completely. Unit labor costs have not declined as advancing technology would lead us to hope for. More relatively obsolete capacity remains in American industry than most Americans realize.

Some industries face especially great pressure. Electric utilities, among the most capital-intensive of all, see a demand growth which can be met only with truly huge injections of new capital. The Bell System goes to the capital markets each year for amounts which, though vast in one sense, must be spread over millions of users. The ordinary person expects these utility services to be available for his payment of a few dollars a month. Yet to have these facilities of production and distribution available, public utilities must make prior investments of large capital sums.

HOUSING, STATE-LOCAL, ENVIRONMENTAL, AND OTHER CAPITAL NEEDS

Merely mentioning *housing* should call up some picture of other needs for new capital. What magnitudes? For several years the annual rate of *net* household formation will be about 1,400,000. To add this many units at an average construction cost of $17,000 ($24 billion) would in itself require almost one-third as much as all the country's new savings. And improving the average quality of today's 60 million units moderately—gradual replacement of slums, replacing demolitions, and improving broadly—could cost as much without doing the job rapidly.

School and water and sewer and other districts will want to sell bonds to finance new facilities. The dollars must come from somewhere. State and city governments will keep coming to the capital markets for funds to finance projects of many types. The dollar amounts sought will exceed the totals from the repayment of earlier borrowings. Net growth of such debts must be financed out of the net additions to savings. State-local governments as claimants upon the flow of new savings will compete with industry and housing for whatever supply is available.

Finally, but not by any means minor—very much major in fact—are claims on industry (and on local governments) for new capital facilities of types which will do little or nothing to raise productivity as it is measured. Anti-pollution and other environmental needs can absorb billions a year without yielding much or anything in the way of salable product. Hopefully, benefits to the public will amply justify the costs. But those costs must come from somewhere. To considerable extent they will take capital funds which would otherwise be available for new housing, plant expansion, cost-reduction techniques, and so on. The pressures to improve the environment do not seem likely to generate much new saving, but they will put greater demands upon the supply.

SUPPY OF NEW SAVING [24]

The American economy today, with rising population and rising aspirations, requires huge amounts of new capital (and saving) to approximate the realization of expectations. What are the prospects? They are not good enough to prevent the considerable frustration of disappointed hopes.

On the average, families save somewhat over 6% of after-tax income, net (taking account of new borrowing, the growth of pension funds and life insurance reserves, debt repayment, and the consumption of prior savings, as by persons retired). Sometimes, as from late 1970 and into 1972, the figure gets over 7%. Sometimes, as from 1961 and mid-1960's it was less than 6%. An average of 6% would now (1972) yield around $50 billion a year.

[24] Among the most difficult of statistics to compute are net savings. Despite refinements in concepts and the improvement of sources of basic data, official figures on net savings are not so reliable as most aggregates for the economy.

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A savings rate of somewhat more than 6% of the *rises* in personal income, after tax, would be around $3 billion a year. This amount—equal to about $2,000 for each net addition to the labor force—will not pay for a great deal of new capital equipment or housing. When related to a year's population growth, the per capita amount of saving will not be "large."

Considerable uncertainty about the growth of capital arises from questions about corporate savings. Earnings kept in the company (after taxes and dividends) play significant role. But how large will pre-tax profits be? How heavily will taxes bear on corporation earnings? How forcefully will shareholders demand dividends?

A very high level of business activity, and one free from a serious "wage-profit squeeze," will be needed to raise retained earnings by much over $3 billion a year. A more disturbing fact ought not to be ignored as it still seems to be. Very much more than $3 billion a year is "phantom" profit; it is the result of inflation rather than of capital productivity.[25] Depreciation rules (for product pricing and taxation) do not recognize that replacement costs are higher than historical costs. Therefore, expense in the true economic sense is *understated;* and both profit and taxes are *overstated.* The tax laws ought long ago to have been remedied, somehow, to eliminate this distortion and deception. But no direct adjustment has been made. So Uncle Sam and state governments tax *capital recovery* as if it were earnings, *i.e.*, returns *to* capital rather than returns *of* capital. Government consumes capital, not only in the form of death tax, but also under the guise of profits tax..

Looking ahead, we can say that the normal growth of saving will not provide the capital needed to meet rising expectations.[26] Perhaps, the "shortfall" will not seem large. Perhaps it will not be recognized as a shortage of saving. The adjustments would occur at many places and frequently in undramatic ways. But disappointment and frustration would plague society at many points. The amounts of savings needed for more probable levels of aspirations—in both housing and jobs—would cost much more than our savings could finance.

INELASTICITY OF SUPPLY OF CAPITAL FACILITIES

If we want more brown shoes, vanilla ice cream, or tennis balls, the output can be increased in large amounts and rapidly. Supply has elasticity such that quantity can be raised or lowered in large percentages within a short time. By spending more, and probably paying somewhat higher prices, we can within a few months get a big expansion of the amounts which become available. For some things a year or even more may be required for large increases in quantity, but will suffice.

The stock of capital, however, is different. The quantity of capital goods we shall have available next year depends predominantly upon actions in the past. What can be done in one or a few years to increase the total stock will, at the most, enlarge the aggregate only slightly.

The stock of capital represents the accumulations of generations. It probably represents over 30 times one year's net additions.[27] If by a tremendous effort we were to increase greatly the annual flow of savings into new housing and other capital goods, quite some time would be required for the total to be altered substantially. Thus, actions to raise or lower the death tax absorption of capital

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[25] The $3 billion is almost five times the average of the 1960's. "Cash flow" figures are used frequently but are apt to be misleading. Depreciation funds do help to pay for replacement; and it is a part of gross investment. But replacements do not provide for net expansion of productive capacity except as improvements in technology are included *without a comparable rise in cost.* Because of inflation the amounts charged as depreciation probably fail by a significant amount to pay for replacement at current prices. See George Terborgh, *Essays on Inflation* (191); and Tax Foundation Inc., *Depreciation Allowances: Federal Tax Policy and Some Economic Aspects* (1970).

[26] Obviously, the statement in the text suffers from imprecision. The author's own judgment of the expectations of others may be wide of the mark. The competitive "promises" of political campaigns, and the skilled talent which prepares the advertising around us, as well as the examples we see (the "demonstration effect"), are among the forces making for general rise in aspirations.

[27] Measurement is exceptionally difficult. Estimates for 1967 show national wealth as $2,838 billion. Structures, including housing and governmental, accounted for 51%; producer durable goods were 12%. Consumer durables, business inventories, land, monetary metals, and net foreign assets made up the balance. Bureau of Census, *Statistical Abstract of the United States,* 1970, p. 334. Housing and business combined to 58% or $1,640 billion. Gross private domestic investment in 1967 was $117 billion (inventory but not consumer durables being included). Capital consumption allowances were estimated at $69 billion. The net addition to capital by this calculation was $48 billion. The estimated capital stock, as included above, was about 34 times the year's net addition.

would have only moderate effect on the total after one year. The powerful cumulative effects work out only over time.

The difficulty of showing dramatic results may hamper understanding. In a few years, however, the difference could be appreciable, very well worth sacrifices. But some of the people who would benefit most, future workers and consumers, do not have votes in today's elections. The cumulative effects of higher taxes on estates and gifts which curtail the growth of capital would not be vividly clear in any one year—not perhaps even identifiable as such.

TAX STRUCTURE AND THE GROWTH OF SAVING

The steep graduation of personal income tax rates—from 19% on marginal income over $4,000 (married couple) to 25% just over $12,000 and 36% over $24,000—must hamper the growth of saving. (State tax rates are in addition.) For a single person, Federal and state taxes can take over half of each dollar above $18,000. As pre-tax income rises from year to year (partly from inflation), the dollars of rise fall in higher brackets. Thus, progressively more will be taken by income taxes. Death tax revenues also go up relatively more (at a higher rate) than national income.

Federal and state gift, estate, and inheritance taxes will reduce private wealth by over $5 billion in 1972. Graduated (progressive) rates plus inflation will tend to increase the "take" by government from year to year. But the amounts as related to savings have gone up in the last 20 years.[28]

FEDERAL AND STATE DEATH AND GIFT TAXES

[As percentage of]

Year	Personal savings	Personal savings plus undistributed corporation profits
1950	9.21	4.18
1955	7.15	4.23
1965	13.16	7.03
1969	11.68	6.89

TAX BIAS AGAINST CAPITAL

Over the years Americans have biased their tax system against capital and the suppliers of capital. While comparison of the taxation of human beings in their capacities as laborers and as suppliers of capital presents some sticky problems, and can lead to unproductive argument, some points do warrant attention.

First, death and gift taxes fall on (owners of) capital. With the abolition of head (poll) taxes, is there anything comparable on human capital? No.

Corporate earnings are generally taxed at 48% (22% up to $25,000) at the margin but with state taxes in addition. Shareholders are then taxed on dividends. Since the repeal (1964) of the 4% dividend credit, there is no longer any adjustment (except for the $100 dividend exclusion) at the stockholder level for tax already paid by the corporation. Wages, salaries, interest, and rents are taxed once. Earnings of equity capital of corporations which are paid out to stockholders are to some extent taxed twice (some probably being shifted to consumers).

Much real (physical) capital is taxed in a way not applied to human beings—by local property taxes on buildings, machinery, and inventory. This tax now often equals or exceeds 3% a year on *full capital* value; it can represent an appreciable fraction of the value of what the caital facility produces. State and local sales taxes frequently apply to capital goods, producers equipment, as well as to the later output when sold at retail sale; the same value, the capital input, is thus taxed twice.

The personal income tax applies to the earnings of millions of unincorporated businesses, including the fruits of capital as well as of labor. With graduated personal income tax rates as they are today, the tax falls on business earnings more often, and in larger amounts, than most Americans would probably expect.

Successful businesses cannot accumulate capital out of income as fully as the

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[28] Calculations supplied by Tax Foundation, Inc.

economic prospects would justify. In slightly different words, taxes hamper firms in which the productivity of labor and capital would amply justify more investment. Small companies and new ones—as well as older and larger firms—feel stresses and strains which appear as shortages of capital.

Are there tax features which favor (owners of) capital? The one most likely to be cited will be the postponement of tax on accruing capital gains (including some gains which represent a conversion of the yield of capital from rent, interest, or profit) combined with the possibility of escaping income tax on gains held till death. For successful investors, considerable enhancement of personal wealth can come about without the payment of a personal tax on the increment.[29]

Over the longer run, of course, much of the rise in asset prices consists of retained corporation earnings which (if not shifted otherwise, *e.g.*, to consumers) have already been taxed once.[30] The yields of assets in pension funds are quite generally not subject to tax until received in benefits (but in fact may then be nontaxable because of the double personal exemption for persons over age 65) ; as the year's investment income adds to the corpus, no tax is payable. Therefore, retirement funds can grow more rapidly than if the yield were taxed currently. The value of an owner's occupancy of his house—income which in an economic sense is imputable to his investment of capital in the residence—is not subject to personal income tax; but property tax often rests heavily on this form of consumption.

CONCLUDING COMMENT

Moderation of the tax burdens estates and gifts, as well as on potential saving and the yields of caiptal, could help in providing funds to finance the growth of productive capacity.[31] "Needs" for capital will be higher than the probable supply will meet.[32]

Society today has a problem which few Americans have faced consciously and deliberately. It involves, among other things, taxes at death and on gifts. These revenue sources fall heavily (per dollar of yield) on the potentials for growth of capital facilities. A conflict exists, but it is generally ignored, a conflict between a desire to put costs of government upon one group and a desire for a life which requires more capital goods.

Influential groups have concepts of equity in sharing the costs of government which often involve relatively heavy burdens on savers and on the owners of capital. The Treasury proposal, however, seeks more equitable taxation—in this case by the rearrangement of burdens, not necessarily increasing them in total. Other advocates of change, however, may seek to increase total burdens, more or less without thought for the effects on capital formation.

Conceivably, Congress in a desire to aid capital formulation might reduce total death tax revenue. But in view of expenditure growth does not pressure in another direction seem more probable? The opportunity created by an opening of these taxes for modification could be used to get more revenue. This possibility ought not to stand against effort for reform. But precautions are called for.[33]

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[29] The progressive performance of the economy in the quarter century since World War II despite high corporate and personal tax rates, may quite possibly be explained in part by the fact that the tax rates have not actually applied in full. The special treatment of capital gains has in fact moderated the combined force of taxes.

[30] The text discussion, admittedly, fails to give adequate weight to inflation and to the special forces which influence land prices. The conclusion stated does need some qualification, but the central point stands.

[31] Federal budget deficits draw upon the funds otherwise available for private investment in capital goods. Complex issues can rise in discussions of the financing of a Treasury deficit. Under foreseeable conditions of active demand for capital for housing and other investment projects, the "conservative," "old-fashioned" (but not always obsolete), conclusion remains valid: The government's use reduces the availability to the private sector. The possibility of using the money-creating (banking) mechanism does not alter the picture in this respect; the newly created bank deposits (credit) would be used privately if government were not taking it.

[32] Estimates made by the author in 1971 now seem somewhat inadequate. They suggested that by reasonable interpretations Americans would expect or aspire to conditions which would necessitate some $15 to $20 billion more savings a year than are likely to be forthcoming. C. Lowell Harriss, "Revising Estate Taxation," Tax Foundation, , Inc., XXXII *Tax Review,* at p. 16. A more recent run-through of the estimates indicates that as of, say, 1972 the shortfall would be more than slightly greater. No immediate, short-term forecast should be implied; changes over a few months can significantly affect the totals for a year or so. The present exercise, however, seeks to understand the operation of longer-run forces.

[33] One part of the death tax problem, the payment of tax on interests in closely owned businesses, would be aided by elements of the Treasury proposals. From the time the author first studied the general problem (in the Treasury in 1941), he has been convinced

The taxing of capital gains at death would be a far-reaching change having tempting revenue potential. Why not, it might be argued, get *more* revenue when people die by adding this element? The new burden, as indicated earlier, would fall heavily on capital.

What might be learned from experience? The growth of Federal spending to meet much-advertised needs has in fact led to taxes which actually accentuate many needs. The notion that the good things from spending can be obtained without bad things from taxation is not merely romantic folly. Worse—it can mislead, to taxes whose harm exceeds anything taken into account when the decision was made. Such is the case with taxes which, per dollar of revenue, fall heavily on capital accumulation.

Congress faces—and Congress itself generates—enormous forces for still greater expenditure. How tempting to get more funds by using tax sources which in any one year directly affect only a few people! The ones obviously hit by heavier tax burdens at death would be members of upper wealth groups. Would it not be politically tempting to get more revenue by curtailing these provisions—close "loopholes"—which now favor the taxpayer *without* reducing rates and adopting the other changes proposed by the Treasury to keep total burdens from rising? Such argumentation might have political appeal. To meet such arguments on their merits requires more than emotion. Heavier taxes at death would make more difficult meeting those many aspirations which require capital.

The defects of today's estate and gift taxes challenge us to modernization. In doing so, the effects on capital formation deserve explicit attention. Society's ability to meet rising expectations will depend upon capital formation—calling for larger amounts than will be forthcoming under foreseeable conditions. The finance of government services by taxes which, per dollar, of revenue fall heavily upon saving can be "greater" or "lesser." The effects of death tax revision on the economic capacity of the future call for careful evaluation.

Representative REUSS. Thank you very much, Mr. Harriss. We will now hear from Mr. and Mrs. Ott.

STATEMENT OF ATTIAT F. OTT AND DAVID J. OTT, PROFESSORS OF ECONOMICS, CLARK UNIVERSITY

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

We too would like to join our colleagues in expressing our thanks for the opportunity to be here, and for the opportunity to present a prepared statement, and also to thank you for the output which has resulted from the tax subsidies studies, which we too feel is essential to the rational attempt to review our tax system and to make wise decisions about possible changes in that system.

I would apologize for Mrs. Ott. She is suffering from the "neighborhood effects" of some of our local environmental problems. And her voice is not up to saying very much. So in case I say something which she finds herself unable to accept, maybe she will raise her hand or punch me in the side or something, and you will know that it is not a unanimous view.

My oral presentation is to concentrate primarily on, (1) summarizing the paper presented in the compendium—very briefly I will attempt to do this—and then to reiterate some of the highlights of the prepared statement which we submitted for inclusion as an exhibit.

So first let me recapitulate briefly the conclusion of our compendium paper. I am always amazed at how much study is given State and local tax exempt securities relative to the revenue implications of this

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that the general public welfare would be advanced by easing the payment provisions. Much has been done, including changes voted in 1970 along with the speed-up provisions. The kinds of businesses involved are important, not only to the owners and their heirs but also to employees and customers and to the whole economy in ways not always identifiable. Space does not permit discussion here except to express support for adjustments of the type recommended.

particular issue. And I suggest to you that there is probably a principle here; namely, that we can't judge what is important and what is not important by the amount of revenue involved; a number of other things are involved.

In our paper we first sought to make once again, hopefully with some improvement in technique, the point that, as it now stands, the exemption of interest on State and local government securities, which is in its essence a subsidy to State and local government capital formation, is an inefficient subsidy, in the sense that if we wanted to achieve the same results, they could be achieved with some other approach which would cost the Treasury much less than the cost under the present system, and generate the same amount of capital. We presented no new estimates, but relied on the previous estimates. Of the issues made in 1969 of State and local government securities, the cost to the Treasury will be about $2.6 billion, and the State and local governments will save $1.9 billion. We had $700 million of "slopover," if I may use that word; that is, payments through the Treasury to State and local government that weren't needed to get the results we got.

And we next reviewed the obvious points about equity that have been made many times in the past—that the exemption of State local bonds creates inequities in the Federal income tax structure by both reducing the progressivity of the tax system—the vertical equity problem—but, perhaps more important, it reduces the horizontal equity of the tax; that is, it results in taxing people with the same incomes in different amounts.

Third, we sought to add something new to previous studies; namely, a rough estimate of the effect on the allocation of capital by sector of just this one provision in the tax law. Our rough estimates rest on a number of somewhat crude assumptions, primarily that the net rate of return on capital is equated in each sector. Given these assumptions, we estimate that in effect the subsidy increased State and local capital formation by 25 percent over what it would have been without it, or to put it another way, if they had not had an exemption, their capital formation in the 1950's which is the most recent period for which we had data available for this use, would have been 25 percent less. These results suggests that the resource allocation implications are significant, and perhaps this explains why people are so concerned about this provision, particularly people at the State and local government level. At the same time we pointed out that it may also well be true that the exemption feature tends not only to cause State and local governments to invest more in physical things—in capital goods—than they otherwise should, but to some extent which we don't know yet, it biases their choice between using other inputs and using capital. I am always struck by the number of school buildings and other State and local facilities which sit idle much of the year. Perhaps this is an example of some of the distortions of this type caused by the interest exemption.

Finally, we reviewed some other literature which points out the cyclical problem faced by State and local governments because of the interest exemption; namely, because commercial banks are heavy investors in this type of asset, and because they generally tend to view it as a marginal investment—they are in the market when they have excess funds in periods of monetary ease and they are out of the

market in periods of tight money when they only meet the demands for loans from their prime users—the State and local governments are subject to an excess burden from tight money. That is, the subsidy puts the State and local governments in the unenviable position of bearing much of the brunt of tight money. So that there is much more fluctuation in tax-exempt issues than there otherwise would be. And this also should be put in the context of what has happened in the housing markets in recent years, where they have been insulated to some greater extent than they used to be from tight money. So we have gotten into a situation now where the State and local governments are really about all there is left to bear the burden and they do, even more so than in the past.

There is also the possibility suggested by some recent studies that there is a secular tendency for Federal revenues to run short of the projected Federal spending program. And if this has to be offset by a secular policy of tight money over the seventies, the interest subsidy poses an even worse problem for State and local governments, because they will be caught in a secular squeeze rather than just a cyclical squeeze for funds.

Now, as all of you know, there have been proposals, the most notable one, I think, by Senator Proxmire—which attempts to get at this problem. I think something is going to happen in this area, and I think this is an area where careful thought ought to be given to what is done. The reason something is going to happen is because if State and local governments are not given an option; that is, if they are not given, as under the Proxmire bill, the option of issuing taxable bonds with a Federal subsidy, they may well find themselves faced with a host of Federal "mini-urbanks," as many people call them; that is, special banks which issue taxable or guaranteed Federal securities and lend funds to State and local governments for special purposes. This has been the thrust of the hospital program, and this has been the thrust of some of the farmers home administration programs, and if nothing is done about the interest subsidy, the Federal Government is going to proceed in each area to create a special bank to avoid double subsidies; that is, to avoid piling subsidies on top of subsidies in the case of tax exempt bonds. So I think the State and local governments themselves are becoming concerned about this problem, and I think this is reflected in some of the support appearing from some parts of that sector for approaches such as the Proxmire bill.

We sought in the paper to stress a point that should be made: You do not get rid of all the inefficiencies of a subsidy by having optional taxable bonds. The higher the Federal subsidy on taxable bonds, the more you drive out tax exempts, but you don't get rid of it all. Furthermore, the optional Federal subsidy is not a revenue gainer, it is probably a revenue loser. But it is probably worth the revenue loss of an optional taxable bond to induce State and local governments to get rid of the inefficiency involved in the present subsidy.

Now, to our prepared statement. Let me just try and highlight a few of the major points made there. We wanted to focus on some points which we have not seen stressed in any of the materials which we have read from your committee or from other sources. These points have been made in some cases, but not stressed, as important to the way we look at the priorities of tax reform.

It seems to us essential that we decide what tax systems we are talking about when we talk about tax reform. Most of the discussions that we have seen in the press emanating from this committee, and from other discussions in the press, have had to do with the individual income tax, and in a few instances, with the corporate income tax. What we suggest is that it is critical to look at the whole ball of wax, not only at the individual income tax but the corporation income tax, estate and gift taxes, and the payroll taxes that finance social security. The importance of this is that if we are going to talk about redistributing income and changing the tax burden of people, we need to look at all the taxes that do this, not just one, not just the individual income tax. And the striking thing is that in terms of tax burden patterns, it makes a lot of difference what you look at. If you look at the individual income tax alone the high income classes as a group tend to look as if they have low tax rates. If you throw in the corporate income tax and assume the corporate shareholders and other owners of capital pay this tax (it is a general tax on capital), it changes the pattern considerably, and makes the overall corporate-individual income tax a fairly progressive tax. And if you add estate and gift taxes to that, there is a minor further increase in progressivity.

Now, let me say just something separate about the payroll tax. Most people tend to treat the payroll tax as a regressive tax. Our point of view is that one should look at the payroll tax in the context of the whole social security system. However, realizing that the social security system is now essentially a currently financed, pay-as-you-go social security system, the key relation is: What does each generation get relative to the contribution that it puts in during its working life? The present system is such that benefits are tilted in favor of low wage earners. And the payroll tax is tilted the other way. One can argue that the benefit tilt outweighs the payroll tax tilt, so that looked at over the lifetime of the individual involved in social security, or looking at the system separately, the payroll tax in that sense may not be a regressive tax. It may even be progressive, although we don't really know the answer to this question at this point.

But most important, we feel that it is essential to decide what you want to do with social security. If you want social security to be a welfare system, obviously, the payroll tax makes no sense at all as a means of financing it. If social security is really to be a social insurance system, where there is a relation between contributions and benefits, it should be restructured that way. And the benefits that are paid, not because they are contributions-related, but for welfare purposes, should be stripped out and put somewhere else and financed by general revenue rather than by payroll taxes.

So, to summarize and try to stay within my time limit, we have suggested the following priorities for tax reform: The corporate tax should be integrated with the personal income tax. We think this is of the highest priority, because to not do so distorts our view of what we are accomplishing in the way of redistribution of income, and affects resource allocation.

Second, we feel a personal income tax instead of the payroll tax should be used to finance the welfare components of social security, that is, that system should be stripped of its welfare aspects and payroll taxes should only be used to finance the rest of the contributions-

related benefits. Payroll taxes would then not necessary be culprits and repressive taxes.

Lastly, we have sought to argue, in terms of what should be taxes and what shouldn't that welfare, or income-conditioned transfer payments, should not be taxed. The basic reason is, if you tax them, and if you want to change your welfare benefits, you have got to change your whole tax system. If you want to pay people a thousand dollars a piece, for example, and get most of it back from higher income people, every time we have inflation and you want to change the basic benefit for your low-income people, you have got to change your tax structure, your tax rate schedules, to offset that as far as your overall revenue objectives is concerned. And it means you almost have to have a different tax system for people receiving this as welfare, and people who end up getting nothing.

Finally—we have suggested seconding Mr. Brannon's point—it is probably not a good idea to look at tax reform as a way of getting revenue, not in the short run. One reason for this is that what one hopes to get in the way of revenue out of tax reform is very much dependent upon what kind of "second-order effects" you induce in the economy as a whole, that is to say, if you try to increase taxes on one kind of income, and you don't close special treatment of other types of income, you may well find people shifting from one source to another, so that your estimate of the gain in net revenue gain is greater than what it actually turns out to be.

Another reason is that, given the fact that we don't know in most cases the exact resource allocation effects of major changes in the tax laws, that we should not just willy nilly have tax reforms to gain revenue, because we are having serious resource effect when we do this. We should consider, in attempting to reform the tax system, mainly the resource allocation effects. Hopefully, in doing so we will achieve something which improves the efficiency of our economy. But I would say at the same time we will not have a very good fix on the revenue implications of a tax law change until we have let it operate awhile.

Thank you very much.

I apologize if I have exceeded my time.

Representative REUSS. Not at all, you have all been well able to stay within the time limit.

(The prepared statement of Mr. and Mrs. Ott follows:)

PREPARED STATEMENT OF ATTIAT F. OTT AND DAVID J. OTT*

TAX REFORM: ISSUES AND PRIORITIES

We are pleased to be able to take part in the study of Tax Subsidies and Tax Reform undertaken by this Committee. The timing of the Committee's efforts could not be better; it seems probable that we are heading toward the third major legislative effort on tax reform in five years. The direction of that effort, however, is not all clear. We have had a welter of proposals introduced—some in the Congress and some in the press. The studies done for this Committee and the Hearings on them should help provide the Congress with some of the information it needs to evaluate these and other proposals and take constructive action in the 1973 session.

For this reason, in our testimony today we will concentrate on a few issues which, we feel, have not been given the emphasis they deserve in previous dis-

*We wish to thank the American Enterprise Institute for Public Policy Research for providing typing services and reproducing this paper. The views expressed here are not necessarily those of the trustees, officers, or staff of AEI.

cussions of tax reform but which are of the utmost importance in setting priorities in this area. These are:

What tax systems should we plan to include in any reform proposal?

What should be the role of tax reform in achieving a desired distribution of income?

What will be the effects on revenues and tax burdens of the reactions of individual and firm to tax reform—the "second order effects" that any major tax reform action would induce?

The answers to these questions are essential in setting priorities for tax reform.

What taxes should be included in a reform proposal?

Most of the recent discussions of tax reform have dealt with the individual income tax. There have been discussions of provisions of the corporation income tax (such as the investment tax credit), discussion of the burden of payroll taxes used to finance OASDHI, and discussion of separate reform of Federal estate and gift taxes. However, relatively little attention has been paid to the question: What role should these taxes play in the Federal revenue system? Certainly we are remiss in any discussion of tax reform if this issue is not settled first. We are certainly misled by any estimates of the distribution of the burden of Federal taxes if we look only at individual income tax burdens. Let us consider in turn each of these other major components of the Federal revenue system and their place in tax reforms.

THE CORPORATION INCOME TAX

In our view, the highest priority in any tax reform proposal should be the elimination of the corporation income tax and the raising of the lost revenue under the individual income tax. There are few features of the present tax system as pernicious as the separate tax on corporate income. It obscures efforts to measure the equity of the Federal tax system, both because it leads the uninformed to believe that *corporations*, not people, bear the tax, and because the informed find it difficult to ascertain which people do, in fact, bear the tax.

Taxes can be *collected* from organizations such as corporations, but *people* ultimately bear the burden of the tax. There has been widespread disagreement among tax experts over which group of people bear the burden of corporation income taxes. Some argue that the corporation's stockholders and their recipients of income from capital bear the tax by having their dividends and capital gains on corporate stock reduced. Others argue that corporations shifit the tax to consumers in the form of higher prices or to workers in the form of lower wages. Irrespective of which school of thought one might subscribe to, the important fact is that *the burden of this tax is obscured*, and it is thus difficult to assess the equity of the Federal tax system when the burden of a very important tax in this system is in dispute. *It seems totally unacceptable to us to continue using a source of revenue when tax experts are unable to agree on who is paying it.*

The majority view now is probably that the corporation income tax falls on income from all capital.[1] There are studies which show that, under this assumption, the corporate tax reduces investment in the corporate sector over the long run.[2] In the face of the additional taxation of income from capital in this sector, the stock of capital has to be reduced to keep *before-tax* rates of return high enough to make after-tax rates of return competitive with non-corporate sectors. We estimate that, as of 1969, approximately $222 billion, or 24 percent of capital that *would* have been put in the corporate sector has not been because of the discriminatory taxation of income from capital there under Federal corporate and individual income taxation.[3] Real GNP may be as much as $12 billion less than it could have been had not the corporate tax thus distorted the use of resources.

Therefore, we strongly favor the complete abolition of the corporate income tax. The income generated by corporations should be taxed as it accrues to people as (1) dividends and (2) gains in the value of corporate stock. Corporate income that would have been received in these forms by households in

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[1] Pechman, Joseph A., "Distribution of Federal and State Income Taxes by Income Classes," *Journal of Finance*, XXVII May, 1972), p. 186.

[2] See for example, Arnold C. Harberger, "Efficiency Effects of Taxes on Income from Capital" in *Effects of Corporation Income Tax*, M. Krzyzaniak (ed.) Wayne State University Press (1966), pp. 107–117; and "The Incidence of the Corporation Income Tax", *Journal of Political Economy* (June, 1962), pp. 215–240.

[3] David J. Ott and Attiat F. Ott, "The Effect of Non-Neutral Taxation on the Allocation of Capital by Sector," *Journal of Political Economy* (forthcoming).

1972 (assuming a steady state—capital gains is equal to retaining earnings) without the corporate tax, would be about $73.3 billion or 77 percent of corporate income. Adjusted Gross Income would include $21 billion of this as taxable income.[4]

The corporation income tax, as a tax on income from capital, is progressive because capital income is a larger proportion of total income of high income families than it is for low income families. This is shown by Pechman's data presented in Table 1.[5] Without the corporation income tax, the highest average effective tax rates under the individual income tax are around 16½ percent for those families in the $50,000–$500,000 income classes. When the burdens of the corporation income tax is added, the maximum average effective rate occurs in the highest income class ($1 million and over) and is 42 percent—29.4 percentage points being contributed by the corporation income tax.

TABLE 1.—EFFECTIVE RATES OF FEDERAL AND STATE, LOCAL INDIVIDUAL AND CORPORATION INCOME TAXES, ASSUMING HALF THE CORPORATION TAX IS BORNE BY OWNERS OF CORPORATE CAPITAL AND HALF BY OWNERS OF CAPITAL GENERALLY, BY ADJUSTED FAMILY INCOME CLASSES,[1] 1966

[In percentages]

Adjusted family income class[1] (thousands)	Effective rates		
	Individual income taxes	Corporation income taxes[2]	Total
All families:[3]			
0 to $5[4]	2.7	2.3	5.0
$5 to $10	6.2	1.6	7.8
$10 to $15	8.2	1.5	9.7
$15 to $20	9.4	2.2	11.6
$20 to $25	10.0	3.4	13.4
$25 to $50	11.5	5.7	17.2
$50 to $100	16.7	19.4	35.8
$100 to $500	16.4	19.4	35.8
$500 to $1,000	14.7	27.0	41.7
$1,000 and over	12.7	29.4	42.1
Total	9.0	4.0	13.0

1 Adjusted family income includes corporation income tax for the purpose of calculating effective rates, and for the purpose of classification by income classes.
2 Assumes half the corporation tax is distributed on the basis of dividends and half on the basis of total property income in adjusted family income
3 Includes unattached individuals.
4 Excludes families with negative incomes.

Note: Figures are rounded and may not add to totals.

Source: Data based on the MERGE file for 1966. Classification by major source of income is based on adjusted gross income as defined in the Internal Revenue Code.

It is thus clear that when the individual and corporate income taxes systems are considered together, the Federal income tax is much more progressive than when the individual income tax alone is studied. At the same time, the progressivity is achieved by discriminating against one particular form of income—the income from corporate capital. In principle, this is as bad as the provisions which *favor* income from particular sources, such as interest on state and local bonds, sick pay, capital gains, etc. Thus the progressivity provided by the corporate income tax is no more a defense for it than would be the progressivity of a special tax on the value of yachts. The only basis for either tax would be that the thing taxed produces social costs or "external diseconomies" which would lead us to desire a reduction in its use. While such an argument might be relevant for boats or private planes or cars, it does not seem to us to have any application to the corporate form of organizing business activity. Even if it did, we should not tax the net income of corporations but impose a lump sum tax on the corporation or on the value of the corporation.

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4 Approximately 23 percent of corporate earnings is received by non-profit and tax-exempt organizations. If stockholders bear the burden of the corporate tax, then its elimination will cause the government to lose the revenue from corporate taxes currently being paid by these non-profit and tax-exempt organizations, and it would be shifted to individual taxpayers. To avoid this, a special tax would have to be imposed on the corporate income received by the non-profit sector that would raise the approximately $6 billion of corporate tax in 1972 (or 23 percent of the total) currently borne by the non-profit sector.
5 Pechman, Joseph A., *op. cit.*, p. 188.

Thus we argue that eliminating the separate tax on corporate income is of the highest priority. We would then know who pays the tax, we would remove perhaps the single most important cause of inefficiency in the use of resources in the tax system and, as a welcome by-product, greatly simplify the tax system by ending government concern over properly defining the base—there need be no more dispute over appropriate depreciation rules, the investment tax credit, and the like.

However, integrating corporation and individual income taxes would require adjustment of the individual income tax rate schedules. Spreading the burden of corporate taxes over all forms of income, rather than just income from capital, would require a more steeply progressive rate structure to maintain the present pattern of average effective tax rates.

PAYROLL TAXES

It is a widely held view that payroll taxes are regressive, they reduce the overall progressivity of the Federal tax system and are therefore an inferior source of revenue to finance the social security system. Several proposals have been made to eliminate or partially reduce payroll tax as a means to finance social security benefits.[6]

The fundamental issue which must first be resolved is: What is the rationale for social security? The existing social security system serves two goals: (a) A *welfare goal*—it guarantees minimum income support for those aged, disabled and dependent survivors covered under the system, and (b) an *insurance goal*—it replaces or moderates the decline in living standards of qualified workers when earnings cease because of retirement, disability or death, whether or not they have adequate income from other sources. The insurance goal can perhaps be rationalized on efficiency grounds—a compulsory nationalized retirement disability and retirement system may provide benefits more cheaply than private insurance because there is no need for "full funding".

If one views the social security system as serving the welfare goal, then clearly payroll taxes are inequitable in failing to spread the tax burden accordng to ability and in allocating it to only wage earners.

On the other hand, if one views the system as a compulsory social insurance system where benefits are closely related to contributions, then the apparent regressivity of payroll taxes may be misleading. If taxes were computed net of benefits over the life time of each household, present social insurance taxes may be proportional or even progressive.[7]

Because the existing social security system performs the dual, "welfare" as well as the "income-replacement" functions, a high-priority reform is the separation of these two goals. The "welfare" function or the income support function should be transferred to a negative income tax system, a demogrant or to a comprehensively reformed system of public assistance financed under the income tax system. With a comprehensive income maintenance program, attention can then be turned to appropriate changes in the social security system to minimize the inequities that have been caused by the compulsory nature of the system coupled with the attempt to mix welfare benefits with social insurance benefits.

Suppose that the welfare features of social security are stripped away and the system is designed as a baseline insurance system. What changes would this entail? To take advantage of the efficiency argument for social insurance, benefits would be determined by relating them to contributions compounded at the rate of growth of wages. The payroll tax *base* would be set at some percentage of median wages, and payroll tax rates would then be fixed to yield just enough revenues to cover current benefit payments. Under this system, each participant would earn the same rate of return on his "investment" in social security, and the system would grow with median wage income.

Under the present system, benefits are related to "average monthly earnings" (AME) computed by taking average monthly taxable earnings since 1950 (excluding the five lowest wage years). Thus, in 1970, a worker's AME is based on taxable earnings in the best fourteen out of the past nineteen years. However, the relation between benefits and average covered earnings is not the same for all beneficiaries. The present formula has three features which cause wide differ-

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[6] Pechman, Aaron, and Taussig, *Social Security: Perspectives for Reform*. Washington, D.C.: The Brookings Institution (1968). See particularly chapter 4.

[7] For arguments to the contrary, see M. Friedman in *Social Security: Universal or Selective?*, Washington, D.C.: American Enterprise Institute, 1972, p. 35.

ences in benefits for workers with the same AME and substantial variation in the ratio of benefits to AME for workers with different AME's.

First, workers with a low earnings history under OASDI who have achieved fully-insured status receive a *minimum benefit* regardless of the amount they would be entitled to under the formula used for other workers. *Second,* a worker with an AME above the amount which only entitles him to minimum benefits receives benefits that are graduated with respect to earnings. That is, the existing system gives higher benefits relative to average monthly earnings (AME) for those with low average earnings than for those with high average earnings.

Third, benefits are increased or decreased depending upon age, sex or family status of the beneficiary. Although for contributions purposes the basic unit is the worker, the benefits a worker receives on retirement depend upon his own earnings record with discounts or increments for widows, dependent children, and wives. Perhaps the most important of these adjustments differences in benefits is for single and married retirees. Presently, a retired married worker receives 150 percent of the benefit received by a single worker (unless his wife's earnings record makes her own benefit more than 50 percent of his, in which case she draws her own benefit). Furthermore, the wife is entitled to a widow's benefit of 82½ percent of the worker's benefit should he die (when she reaches age 62).

In short, the present system of computing benefits (1) provides substantial "unearned benefits to persons with little or no contributions history; (2) "tilts" benefits for those with substantial contributions histories so that low wage retirees get more relative to their contributions than high-wage retirees; (3) favors workers with rising earnings profiles relative to those with relatively slowly rising wages over their working lives; and (4) gives larger benefits for married workers and workers with dependents than for single persons with the same wage and contributions history. These deviations in the relation between contributions and benefits follow from the dual purpose the System is currently serving; they adjust benefits to redistribute income to serve the welfare objectives of the existing program.

If the welfare aspects of the program are stripped away, these inequities could be corrected. Restoring the relation between benefits and contributions would remove the common concern over the regressivity of payroll taxes. Looked at over each individual's life-cycle, payroll taxes would not be "regressive", since future benefits would be directly related to contributions made on behalf of the worker. General revenue financing of current "unearned" benefits would allow current financing of contributions-related benefits over the next few decades at lower tax rates (given the base related to median wages) than presently programmed. The payroll tax would be reduced and income taxes increased to finance the separate retirement and welfare aspects of the program. In future years, the level of payroll tax rates would largely reflect the ratio of the aged, survivor, and disabled population to the labor force. Table 2 summarizes our rough estimates of the transfer components within OASI benefit system as of December 1968.

TABLE 2.—*Total transfers in OASI, annual rates, December 1968*

[In millions of dollars]

Item	*Amount*
Transfers:	
High to low earners	2,834
Minimum benefits	1,464
Benefit formula	1,370
Retired workers	790
Excess widows' benefits	580
Transfers:	
Earners to nonearners	2,354
Wives' benefit	1,864
Excess widows' benefits	670
Total	5,188

Source: App. A.

Out of about 22.8 billion of OASI benefits in current payment status at the end of 1968 (of the groups covered here), $5.2 billion, or 26 percent, took the form of one type of transfer or another. At fiscal 1973 levels of benefits under OASI payroll taxes could be reduced by about $96.0 with an equal increase in personal income taxes. Such a shift would clearly eliminate the use of regressive taxes to finance the welfare benefits embedded in social security and distribute the burden of its financing to the entire tax population.

In summary, a comprehensive tax reform should not contemplate complete integration of payroll and individual income taxes, but it should encompass shifting the financing of welfare-type benefits in the OASDI system to the individual income tax.

ESTATE AND GIFT TAXES

Gifts, bequests and inheritances are private transfers that enhance the recipient's tax ability in the same manner as income from other sources would do. Yet under the present individual income tax such transfers are not recognized as income for tax purposes. There is no sound reason why such incomes should be taxed under a separate tax system—the estate and gift tax rather than under the personal income tax. Perhaps the only question that may arise in integrating the personal income and estate gift taxes is how to define the tax unit. Under the personal income tax the taxpayer or taxpayer and wife (when filing a joint return) is the unit of taxation while the estate or the donee is the tax unit. To reconcile such differences, the family could be adopted as the tax unit. The family would be defined to include married couples and their dependents, single persons and single persons with dependents. Under this system intrafamily gifts and bequests would not give rise to new income and thus, taxes under the personal income tax, since the family's income position remains unchanged. Transfers of income between family units through gifts and bequests add to the recipient ability or income and they give rise to additional taxes under the personal income tax.

In 1971 some $18 million of bequests and gifts were reported on estate and gift returns with an estimated tax revenue of $3.7 billion. Taxing such income at the personal income tax would yield about the same amount of revenues allowing for averaging. However, the issue here is the same as with corporate income, namely, there is no reason to distinguish between sources of income under the individual income tax.

TAX REFORM AND INCOME DISTRIBUTION

Taxes serve three functions: (1) they are used to divert resources from the private sector to the public sector; (2) to redistribute income; and (3) to affect total output.

The importance of the distribution goal for tax reform is that *the tax system is but a part of the means by which government redistributes income.* At any period in time the distribution of income is affected by taxes, by government transfer payments, and by the pattern of distribution of the benefits of government services. Conceptually, a "most desired" tax system can be designed by looking at the other things the government is doing and then imposing taxes to achieve some desired net economic position of individuals or households. Alternatively, by simultaneously varying taxes, transfers, and the benefit pattern of government expenditures the desired distribution of income can be achieved. This may be explained more easily by using a simple example.

In Table 3 we assume a society consisting of three individuals X, Y, and Z. We begin with the situation A_0, where A_0 defines the initial position of each individual before government activities. Now suppose that A_0 is not the desired distribution of income position, but instead, it is A_1. A tax-transfer scheme could be devised where X and Y contribute ten percent each of their total income. The revenue collected would then be distributed in the form of transfer payments to Y and Z as shown in the table.

TABLE 3.—COMPARISON OF INDIVIDUALS INCOME POSITION UNDER ALTERNATIVE ASSUMPTION ABOUT GOVERNMENT ACTIVITIES

	X	Y	Z
A_0 (original income position)	30,000	5,000	0
T_D (distribution taxes or transfers dollars)	−3,000	−500	0
A_1 (desired income position)	27,000	4,600	3,400
Assumption: (a), (b): (a) Proportional:[1]			
T_A (allocation taxes)	−2,700	−460	−340
G (government services)	+2,700	+460	+340
Net position	27,000	4,600	3,400
(b) Progressive:[2]			
T_A	−2,970	−360	−170
G	+1,350	+460	+1,690
Net position	25,380	4,700	4,920

[1] $T_A = G = 10$ percent.
[2] $T_{AX} = 11$ percent, $T_{AY} = 7.8$ percent, and $T_{AZ} = 5$ percent. $G = 5$ percent, $G_Y = 10$ percent, and $G_Z = 50$ percent.

To provide for government services, a tax, T_A, is now to be imposed on X, Y and Z's income as defined by A_1. If we assume that the amount of government expenditure decided upon for this function is $3,500, the next problem is how to allocate this tax bill between X, Y, Z, and how to measure the benefits of government services received by these three individuals. Since the bulk of government services are of the "social good" type it is very difficult to ascertain, with any allocation of taxes for the provision of government services (T_A), whether or not the final position of individuals corresponds to the "desired" distribution of income position A_1.

Note that in our example the final position of individuals under the proportionality assumption is the same as A_1 due to the assumption that allocation taxes are equal, for each individual, to the benefits from government expenditures. In cases where the individual's personal valuation for public goods differs from this assumption, not only will the final income distribution position differ from the desired one, A_1, but also no quantitative measure of the welfare position of individuals can be estimated.

The point of this exercise is that government, through taxes, transfers and expenditures, determines a "welfare outcome" for each individual in society. It does this whether or not such decisions are made with a desired income distribution in mind. Thus any tax reform proposal which aims at affecting the distribution of income must be viewed as a part of the overall distributional activities of the federal government. One cannot discuss the "proper" tax structure without deciding (1) what pattern of income distribution society wants, and (2) what is the incidence of government expenditure programs.[8]

Another issue is how tax revisions should treat income-conditioned transfers such as public assistance. It is our view that such transfers should not be part of the tax base because they are essentially negative tax payments. If, for example, the government wishes to supplement a family's income by $2,000, then every change in tax rates requires a compensating change in the transfer payment. While this is not impossible to accomplish, it makes the task of estimating the revenue effects of tax changes more complex, since we must iterate back and forth between the tax change, the transfer adjustment, the impact on revenue and back to the tax change again.

In our earlier example (Table 3), the tax base would then be defined as A_0 plus transfers.

[8] A study by one of our students shows that when the benefits of government expenditures on education are considered along with taxes paid to finance them, the net distributional pattern is probably progressive. G. Garrison, *Tax-Expenditure Analysis of Public Education*, unpublished Dissertation, Clark University, 1972.

TABLE 4.—ALTERNATIVE DEFINITION OF THE TAX BASES AND IMPLICATION FOR DISTRIBUTION OF INCOME

	X	Y	Z
A_0 plus transfer payments (tax base)	30,000	5,100	3,400
Tax rate, 10 percent	−3,000	−510	−340
New income position	27,000	4,590	3,000
Change in positions	0	−10	−340
Required change in tax rate (percent)	0	−.02	−.10

As Table 4 shows, tax rates on the new base (A_0+Tr_D) would have to be adjusted if A_1 is to be achieved. If the old tax rate of 10 percent was retained and applied to the new base, the relative positions of X, Y and Z would not be the desired pattern indicated by A_1. Y and Z are now worse off than before. Assuming A_1 to be the desired distribution position Y and Z would have to have their tax rates (on the new base) reduced to restore them to their former positions. In short, adding transfer payments to the base means that either: (1) tax rates for transfer payment recipients be cut; or (2) transfer payments must be raised to compensate them for their loss. Either outcome is untenable; it would be infeasible to have separate tax rate structures for persons receiving transfer payments and if they are compensated by additional transfer payments, their taxes will increase, further compensation is needed, taxes rise, etc. Perhaps more important, every time Congress changes transfer payments, tax rate adjustments or some complicated scheme of transfer payment adjustments for increases taxes would be needed to avoid vitiating the intended purpose behind the change in the amounts of transfers paid.

This same problem applies to plans such as the much discussed demogrant of $1,000 per person, in that every attempt to change tax rates would involve revision of the demogrant to provide the same net benefit to recipients. It seems more efficient to us to calculate taxes on a base that excludes such benefits, with revenues set to cover the cost of the desired transfer payment program.

TAX REFORM AND RESOURCE ALLOCATION

In our compendium paper on the tax treatment of interest on state and local bonds, we noted that in this area considerable effort has been expended to attempt to ascertain the impact of "second order effects"—tax reform-induced shifts in assets—on the estimated "first order" revenue effects. Unfortunately, such efforts have not been devoted to analyzing the second-order effects of many other tax reform proposals. The impact of the corporate income tax on resource allocation has been subjected to empirical analysis, as we noted earlier, and there have been other studies of the effects of taxes on the supply of labor, the savings note, and the stock of owner-occupied housing.[9] By and large, though, most tax reform legislation has not been accompanied by careful consideration of the second order effects it could produce.

Yet such analysis is vital, not just to pinning down the revenue effects more precisely, but as an aid to determining the priorities in tax reform. We have already suggested that major reform should give high priority to remedying the distortion of resources produced by the corporate income tax. In general, analysis of the resource effects of specific tax provisions is a major step in deciding which provisions of present law should be placed high on the list for change. For example, the tax subsidies we give housing also produce significant resource shifts (into the housing sector and mostly at the expense of the corporate sector). Obviously, such subsidies must be largely based on the idea that there are social benefits from home ownership. But is the benefit worth the cost of output lost from causing shifts in resources to less efficient uses? And so on down the line—an estimate of the "waste" caused by each tax provision would provide a useful yardstick against which to compare the supposed social benefits brought about. Since different people will have different judgements about the value of the social benefits of each present law tax provision, there will be no "right" answer in each case. But estimating the "waste" involved in the tax-induced resource shifts will at least provide a yardstick for comparison.

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[9] The most useful volume in this respect is probably the Brookings volume on *Taxation of the Income from Capital,* Arnold Harberger and Martin Bailey (eds.), Washington, D.C.: The Brookings Institution (1970).

CONCLUSIONS

We have argued that certain priorities for tax reform can be established: (1) The corporate income tax should be integrated with the personal income tax; (2) the personal income instead of the payroll tax should be used to finance the non-contributions-related benefits under social security; and (3) welfare benefits conditioned on income should not be taxed. We have also noted that tax revision is an efficient means of redistributing income, but that the goal of redistribution is obscured by our lack of knowledge of the benefits of government expenditure programs. Finally, we have suggested that it is most important to attempt to estimate the "second-order" effects of possible tax revisions (as well as the whole package). Such effects may affect the revenue estimates, and more important, they provide a basis for discussing the alleged social benefits (or losses) from existing provisions in the law.

APPENDIX A—ESTIMATES OF MAJOR WELFARE ELEMENTS IN THE OLD-AGE SURVIVORS SYSTEM (OASI); TRANSFERS FROM HIGH- TO LOW-INCOME WORKERS; TRANSFERS FROM EARNERS TO NONEARNERS

THE OASI BENEFIT PIE

At the end of 1968, the OASI benefits in current payment status we are concerned with here were about $19.6 billion, as shown in Table 1.[1]

TABLE 1.—NUMBER OF OAI BENEFICIARIES BY TYPE OF FAMILY AND BENEFIT BEING RECEIVED

Type of family	Number of families (thousands)	Number of beneficiaries (thousands)	Average monthly benefit	Total benefits annual rate (millions)
Retired worker	12,427	15,585	$111.40	$16,604
Worker only	9,641	9,641	95.00	10,990
Worker and wife	2,432	4,862	166.30	4,853
Other	354	1,082	(1)	
Widows and widowers	2,860	2,860	86.70	2,976
Total	15,287	18,445		19,580

1 No data.

Source: Social Security Bulletin, Annual Statistical Supplement, 1968, p. 107.

TRANSFERS FROM HIGH- TO LOW-INCOME WORKERS

Three features of the OASI system result in a transfer of benefits from high earner families to low earner families.

The Minimum Benefit

Under present law, a worker can qualify for the minimum benefit by working as little as six consecutive quarters under OASI-covered employment. The minimum benefit was long viewed as a needs-related element in the program, and indeed many families who receive it would either be poor without it or are still in poverty even though they receive it. However, in recent years, increasing attention has been focused on the fact that a large proportion of families receiving the minimum benefit are relatively affluent retirees (particularly former employees of the Federal Government) who are in no sense in "need". Recent estimates suggest that increasing the minimum benefit is only roughly 50 percent "poverty effective," that is of an increase in the minimum benefit only one-half goes to families classified poor by HEW standards.

The minimum benefit is virtually totally unearned, since most recipients have contributed miniscule amounts. In 1968 the minimum benefit was $55 per month (it has since been increased to $84.50 by the 1969, 1971, and 1972 amendments). Table 2 shows our estimates of minimum benefits in current payment status (annual rate, end of 1968). The total of $1.5 billion was derived by looking at

[1] Total OASI benefits in current payment status at the end of 1968 were over $22.8 billion (*Social Security, Bulletin, Annual Statistical Supplement,* 1968, p. 45). The major category omitted here is dependent children ($2.6 billion).

the breakdown of workers by size of benefits as presented in the *Social Security Bulletin, Annual Statistical Supplement* (1968, p. 94). Our estimate is roughly in line with the OMB figure of $1.6 billion for Fiscal 1970. (*Budget of the United States, FY 1972, Special Analysis I*, p. 184).

TABLE 2.—*Number of retired workers' families receiving benefits based on minimum PIA and estimated benefits received, annual rates, end of 1968*

Number of benefits in current payment status with $55 PIA:	
With no reduction for early retirement	1, 117
With reduction for early retirement	1, 077
Estimated benefits received, annual rate [1] (millions):	
Benefits not reduced	726
Reduced benefits	638
Total	1, 464

[1] Obtained by multiplying the average monthly benefit by 12 and then by the number of benefits in current payment status. For reduced benefits, the average was assumed to be $48, or 88 percent of the unreduced benefit, the average percentage of all reduced benefits of the benefit before reduction (SSB, 1968, p. 97)

Benefit Formula for Retired Workers

The formula used to compute OAI benefits is tilted in favor of low earners. The formula works as follows:

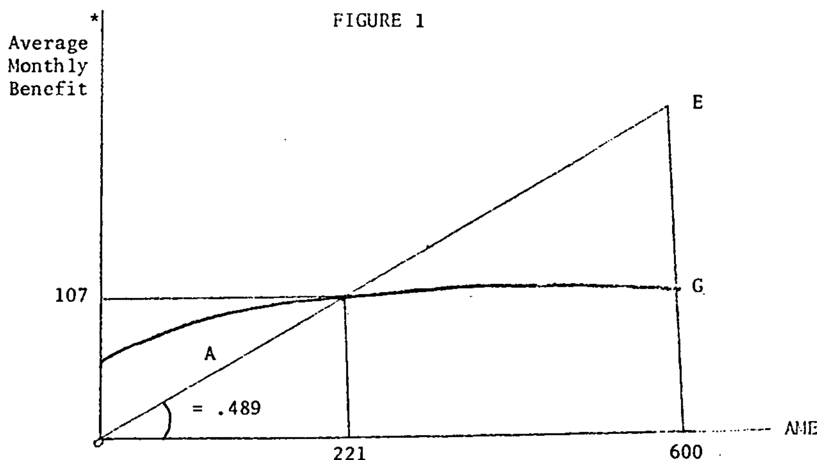
1. The retiree's average covered monthly earnings (AME) since 1950 are computed, after removing the lowest five years of earning experience.

2. The retiree's primary insurance amount (PIA) is computed from his AME using a formula. In 1968, this was:

$$PIA = .7116\ (1st\ \$110\ AME) + .2588\ (next\ \$290\ AME) + .2418\ (next\ \$150\ AME) + .2843\ (next\ \$100\ AME).$$

In short, the low earner (below $110 AME) had a 71 percent replacement ratio, while higher earners have lower replacement ratios (but, strangely enough, the marginal replacement ratio falls up to the first $550 of AME and then rises slightly thereafter. This "tilt" continues, over time, since every time benefits are increased across the board, the percentages in the formula are generally raised by the desired percentage increase in benefits and the upper AME class is extended.

Graphically, the relation between benfits (which, for most retirees is equal to their PIA with allowances for wives, dependents, etc.) and AME is shown in Figure 1 (for 1968).



*For retired workers without wives, husbands, or child benefits. The amount of these additional benefits is related by various percentages.

Our technique for estimating the dollar amount of transfer of benefits resulting from the computation formula was to assume that the *average replacement ratio* for all retirees (without actuarially reduced benefits) measures the "earned" benefit. Thus, in Figure 1, we sought to estimate—for retired worker benefits only—the area designated "A", which represents the excess of benefits received by low AME workers over what they "should" have received based on the assumption that every worker should have the same replacement ratio (indicated by the slope of the line OE, in Figure 1, approximately 49 percent). *By looking at the distribution of workers by benefit amount we estimated the amount that they would have received with 49 percent replacement ratio compared to what they did receive under present law.* The excess benefit per worker was then multiplied by the number of workers in each benefit class to obtain total excess benefits shown in column (3) of Table 3, which are about $439 million.

TABLE 3.—RETIRED WORKERS: NUMBER BY SIZE OF BENEFIT (NO REDUCTION FOR EARLY RETIREMENT)

Monthly benefit class (1)	Number of beneficiaries (in thousands) (2)	Excess benefits (in millions) (3)
Less than $55	0	
$55	[1] 946	
$55.10 to $78	938	$228
$80 to $89	546	109
$90 to $100	554	79
$100 to $110	562	23
$110 to $120		
Total		439

[1] Minimum beneficiaries (already counted).

The same procedure was followed (Table 4) for retired workers with actuarially reduced benefits, except that here we compared the benefit *before* reduction to what they "should" have received, without any reduction. Furthermore, even though this group had a much higher average replacement ratio (around 70 percent)[2] we continued to use the replacement ratio for those who did not choose early retirement. Column (3) of Table 4 shows that some $351 million of excess benefits was being received by this group at the end of 1968.

TABLE 4.—RETIRED WORKERS: NUMBER BY SIZE OF BENEFIT (EARLY RETIREMENT)

Monthly benefit class (1)	Number of beneficiaries (in thousands) (2)	Excess benefits (in millions) (3)
Under $55	[1] 1,069	
$55	21	0
$55 to $70	814	$7
$70 to $80	541	216
$80 to $90	472	71
$90 to $100	402	57
$100 to $110	371	0
$110 plus		0
Total		351

[1] Minimum beneficiaries (already counted).

Widow's Benefit

The third group where the computation tilt shows up is with those receiving widow's benefits. Since the widow's benefit is equal to 87½ percent of the combined worker-wife benefit, she receives an excess benefit whenever her husband's benefit (upon which her benefit is based) had an excess benefit component. Apply-

[2] The high replaced ratio for those with reduced benefits may reflect a reduction which is not, in fact actuarial. Regarldess of whether this is the case, it clearly reflects the fact that low earners are more likely to choose early retirement especially when they are "secondary earners."

ing the same procedure used in the previous cases, we estimate the excess benefit received by widow's of low earners to be equal to $580 million at the end of 1968.

Thus the total excess benefit due to the benefit formula is $1,370 million.

TRANSFERS FROM EARNERS TO NONEARNERS

Excess benefits of this type are dominated by the wife's benefit—which is completely unearned—and what we call the "excess widow's benefit" (this is over and above the excess benefit received by widows under the "computational tilt").

The first of these—the wife's benefit—is easy to estimate. At the end of 1968, 2.6 million wives had average monthly benefits of $54 in current payment status. (*Social Security Bulletin, Statistical Supplement*, 1968, p. 79.) The excess is thus estimated at about $1,684 million.

The excess widow's benefit reflects the fact that she receives 87½ percent of the *combined worker-wife benefit* in effect before the death of the husband. Thus, if the husband and wife together had a combined monthly benefit of $150, then the widow receives 87½ percent of that, or about $132. If the family is viewed as the proper unit of benefit she would be entitled to receive only $100 (which would have been the combined benefit based on husband contribution assuming the wife never worked). Thus, out of total widow's benefits of $2,990 million, about $670 million were excess benefits of this type.

Representative REUSS. We have a number of questions.

Let me start with Mr. Brannon.

Mr. Brannon, how long were you Chief of the tax analysis division at the Treasury?

Mr. BRANNON. About 3 years.

Representative REUSS. You retired within the last few weeks?

Mr. BRANNON. Yes, sir.

Representative REUSS. Were you Chief of the tax analysis division in December 1968?

Mr. BRANNON. Yes.

Representative REUSS. As chief of that division, did you participate in the trailblazing study of the Treasury entitled "Tax Reform Studies and Proposals," December 1968?

Mr. BRANNON. Yes, sir.

Representative REUSS. You had there in that series of proposals what I thought was a very good, sensible, and well worked out proposal on taxing capital gains at death or at gift, with some safeguards, particularly with reference to small businesses, and so on. I take it you still support what you said in 1968. And indeed that is about what you said this morning, is that not so?

Mr. BRANNON. Yes, sir.

Representative REUSS. And while you are somewhat cautious in your testimony this morning about large-scale revenue gains to be made from loophole plugging, you do envisage an ultimate improvement in Federal revenues on the order of $4 billion a year from enactment of this capital gains at death reform?

Mr. BRANNON. Let me make two clarifications.

If you recall the 1968 proposal, one aspect of it was that in order to get over the initial hurdle, for the purposes of this tax on gains at death, we would let people use the value of the stock as of, say, the end of 1968, as a basis—that is up until then they had assumed that this much of the gain would not be taxed at death, and the suggestion in the 1968 proposal was that we ought to say that bygones are bygones and only tax appreciation that occurs after 1968.

Representative REUSS. On the theory that the family cat had probably eaten the records when grandpa gave the stock in 1913.

Mr. BRANNON. That is one aspect of it; yes.

That itself means that the revenue gain on this will grow up rather slowly.

Another aspect of the 1968 proposal was that it was recommended that estate tax rates be reduced. In effect we were making the point on gains at death that the estate tax really hits too hard relatively on wealth accumulation out of dividends and salary, because they have been taxed at income rates during life, and not hard enough on this appreciation on which has not paid income tax. So when you throw in some estate tax reduction, that does offset the revenue gain.

On the 1968 proposal, the net gain out of this wasn't much in the short run.

Representative REUSS. I am correct, am I not, in my impression that neither the Treasury nor the administration has from that date, December 1968, to the present, recommended the enactment of the loopholes-plugging reform suggested in that December 1968 Treasury proposal?

Mr. BRANNON. Part of the discussion as the tax reform bill developed in 1969 was the decision that this matter of gains at death ought to be looked at in relation to a general revision of estate and gift taxes, which the committee said at the time they would take up later, but there have always been other things coming along to occupy them, and the committee has not gotten to the estate and gift tax revision.

Representative REUSS. When I was questioning your former boss, Secretary Connally, in February of 1971, before this committee, I asked him very specifically about the capital gains at death loophole. In the record of the hearings he denied that it was a loophole, but after we got over that semantic difficulty I asked him.

> You do not agree with the proposal of the Treasury Department of December 1968, entitled "Tax Reform Studies and Proposal" in which it was suggested that this method of tax avoidance be done away with?
>
> Secretary CONNALLY. No; I would not say that I would agree with it. I do not think that was a Treasury proposal, I think it was a staff proposal which was never adopted by the Treasury Department nor by the Treasury.
>
> Representative REUSS. And you do not agree with it?
>
> Secretary CONNALLY. No, sir.

That probably accounts for the fact that nothing more has been heard of the December 1968 recommendation, does it not?

Mr. BRANNON. I think so.

Representative REUSS. Mr. Ott, in the prepared statement you have an interesting discussion about the $1,000 demogrant idea which is very much discussed nowadays. I will have to confess that I don't understand it, so I would like some enlightenment from you. What difficulties do you see with the proposition advocated by, among others, Prof. James Tobin of Yale—I think he is the best known of its advocates. The proposition is that everybody should get via a tax credit against his income tax—and if he is too poor to pay an income tax, by a check from the Government the sum of a thousand dollars. What are your difficulties with it?

Mr. OTT. I think the difficulty we have focused on here is that to an economist a payment such as this, where you are trying to effect income distribution, is conceptually simply a negative tax. And it has been called that, as a matter of fact.

Representative REUSS. You are for a negative income tax?

Mr. OTT. I find it conceptually acceptable—I don't want to put myself on record as particularly for this one——

Representative REUSS. But the principle——

Mr. OTT. But the principle is one which has gained wide acceptance, and one which I can find acceptable also. There have always been a number of problems, given any amount you want to spend, in holding down the tax rate at which you tax those people receiving negative taxes. That has been the essential problem.

Representative REUSS. You can very easily have a negative income tax, can you not, which says that everybody with a family income of $8,000 a year—plucking that out of the blue—will get a thousand dollars per family or per head in subsidy. It could then be carried on down so that if you don't pay a tax you get a cash check, and maybe the subsidy is increased as you get near the bottom. Is that your kind of negative income tax in a nutshell?

Mr. OTT. I would say the family assistance plan, for example, is essentially a negative income tax plan for the working poor, that is, for the working poor with more than two people, the working poor with children.

Representative REUSS. It has to be incorporated into a well thought out and carefully calibrated system to make sure there is enough so that there is an incentive to work rather than just take a welfare check.

Mr. OTT. Right. And the problem with that system, in following this since 1969, has been trying to keep the tax rates, that is, the rate at which you reduce their benefits as their earned incomes rise, the problem has been keeping the tax rates down low enough so that these people have an incentive to work. as well as perhaps an incentive to do what they are supposed to be forced to do, namely, work.

Representative REUSS. Having established yourself as not being hard-hearted about a negative income tax, what bugs you about the thousand dollar demogrant?

Mr. OTT. Let me say first of all what does not bug me about it, because I think it fits in with the discussion we were just having. I think this is an attempt, a laudatory attempt to get that tax rates down, that is to say—they have changed the numbers, they differ every time you see them—but to take a family of four, and suppose they were getting $4,000 under this plan, as I understand the most recent proposal from the press, they would be faced with something like 30-percent tax rates should they go out and work, as would everyone else, rather than, as under the family assistance program, something ranging from 67 to 90 percent. And there is quite a bit of difference in the incentive to work when you pay a tax rate of 67 or 80 or 90 percent as opposed to a tax rate of 30 percent. So it has that virtue, that is to say, it has the virtue that the tax rate for families with no income getting the $4,000, should they go out and work, is 30 percent instead of 80 or 90 percent. And that is the reason I think the program has been structured the way it has been, to try to get around this tax rate problem.

The problem I see with it, though, is this—in completely integrating this with the personal income tax system, it means—and this has always been mentioned in the press—it means that over time, as you want to raise the basic benefit—suppose we decide to do with this program as we have done with social security and put in an escalator to take care of inflation—every time you have an escalator effect, or every

time you adjust the basic benefit from a thousand to, say, $1,100, given whatever your revenue goal is, you have to then go and adjust the structure of tax rates—or if not the structure at least the level of the tax rate to offset the effects you have by raising the benefits.

Or, let me put it another way. If you want a distributional pattern of income from this program, and you start off paying a thousand dollars to each person and taxing it back with some tax rate, so that each person ends up where you want him, then if later on you want to adjust the benefits for certain people, namely, those at the bottom, you have got to change the whole structure of rates, as I conceive of it, to keep the other people where you want them; that is, to leave them in the same net position.

So this is just simply a problem of integrating a negative tax and a positive tax, it means that from now on tax writing committees in effect will be concerned with welfare, which is in itself not bad, but it means that in their concern they will have to adjust the tax system every time they adjust welfare benefits, what we used to call welfare benefits, under this proposal. And this is what bothers me. I am not sure that annual, or semiannual, or frequent changes in the level and structure of tax rates, as we adjust essentially the welfare benefits part of this package, are desirable. That is the point.

Representative REUSS. In addition to the difficulty that you have just described, do you see any problem with the $1,000 for everyone, the demogrant proposal in taxing back the thousand dollars you give to Mr. Rockefeller, Mr. Howard Hughes, and so on? This seems to bother some people. Can that be done?

Mr. OTT. Conceptually, yes. I have no conceptual problem with it being done. I think the problem you are going to encounter, and that has already been encountered, is that reading, for example, Professor Tobin's article in the New York Times yesterday or the day before, I think the problem that is going to be encountered is what those rates are going to have to be. And they are still thrashing that out. Because he is talking essentially, as I read it, about taxing virtually all personal income except the imputed items and a few others when he says might not be included (which are not specified). That is where you are going to get into a great argument. In essence it assumes that you close almost all the loopholes that have been discussed before this committee in order to keep the tax rates where he is talking about keeping them. And that is the real hooker in it. If you can't do that, if you can't put those things in the tax base, you are talking about a lot higher tax rate. And that is all it comes down to. I can see a lot of problems. If you are really going to take away some of the homeowners' tax privileges under present law—interest deductions and deduction of State and local property taxes; which seems to be implied if you are going to almost tax personal income—you are going to run into problems of equity between homeowners and nonhomeowners and a lot of other different issues. But that is essentially the issue that you have been facing in this committee over and over again. It assumes you can do this.

Representative REUSS. Thank you.

Mr. Conable.

Representative CONABLE. Thank you very much, Mr. Reuss.

Mr. Brannon, you indicated that you didn't think that a great deal of revenue would be raised initially by changing the rules of taxation

of capital gain at death, because of the sort of conditions that were imposed in your study in 1968. Isn't this true of most tax reforms?

Mr. BRANNON. Yes.

Representative CONABLE. Do not most tax reforms give back in tax relief what you pick in added collections?

Mr. BRANNON. Yes; that is what I say in my statement, that is characteristic of tax reform.

Representative CONABLE. This is not an argument against tax reform.

Mr. BRANNON. I think you should say that it has important benefits in the long run. And I think the Congress should legislate for the long run.

Representative CONABLE. I quite agree with you. I think that taxation of capital gains on death is a very important reform that ought to be addressed. And you are quite correct in stating that the Ways and Means Committee has not requested the Treasury studies on this, that we have had it as a high priority item now for about 5 years, and it is probably going to be a high priority item for a couple of more years. The reason, I don't know. But I personally can't accept Mr. Reuss' position that we are helpless in the face of his exchange with Secretary Connally, and that we must, therefore, sit back and do nothing for the foreseeable future.

What would be the effect if we were to tax capital gains at death and not make any adjustment of estate taxes? Do you have any study as to what the impact would be on the total taxation of let's say, a $400,000 estate, without marital deduction?

Mr. BRANNON. I could only offer some very general, you might say, guesses here, not having the specific rate tables in front of me. I would guess that the estate tax now on a $400,000 estate would be somewhere in the neighborhood of $60,000, without a marital deduction.

Representative CONABLE. If that were largely appreciated assets, then what?

Mr. BRANNON. To be realistic, I think you ought to say that in the long run you might expect that 40 percent of this was appreciation. And then the question arises about the 40 percent or $160,000 of appreciation. The capital gains rate is something of a question. The way it works now you have got this rather complicated business of alternative tax and minimum tax. Let's just guess that the capital gains rate applicable to this would be 30 percent. That gives you about $48,000 capital gain tax. Now, the capital gains tax, of course, is out of the estate. The theory of the 1968 proposal was that this should be treated as though the property had been sold just prior to death, in which case the tax would be paid, and the tax itself would be outside of the estate. So the tax would be a deduction against the marginal estate tax rate. I am guessing that the marginal estate tax rate there might be 35 percent. So we end up with kind of a net addition to tax in the neighborhood of $30,000.

Representative CONABLE. Isn't it true that people with very large estates do not sometimes pay very high inheritance taxes because of the number of foundations and other tax avoidance devices that are also available?

Mr. BRANNON. Some do and some don't. But we do get a lot of money from the tax rolls.

Representative CONABLE. I am wondering if the major impact of such a proposal wouldn't be generally on the middle class like most other tax proposals.

Mr. BRANNON. You might keep in mind that only about 4 or 5 percent of decedents in the United States have an estate tax return filed for them.

Representative CONABLE. Because of the $60,000 exemption?

Mr. BRANNON. That is right. And a smaller proportion of those pay tax, because of the exemption and the marital deduction. So that when you are talking about a medium-sized or small estate for estate tax purposes, you are already talking about the very rich end of the income distribution, if you want to call it a "middle class estate."

Representative CONABLE. I don't think of a $400,000 estate as belonging to a very wealthy person.

Mr. BRANNON. Very few people hit that.

Representative CONABLE. I realize that. But certainly that much accumulation doesn't change the standard of life very much.

Now, let me ask you this. If we go into this kind of reform, isn't it likely that we are going to also make some adjustments with the States on estate tax credits?

Mr. BRANNON. The 1968 proposal avoided that. It suggested that the estate tax credit come out about the way it does now. This credit does seem to me efficient in the long run, if you think of the estate business as part of the total proposition of Federal-State relationships, for example. We are talking now about introducing a new $5 billion of revenue sharing. One would think that you could try to reach a fair Federal-State relationship without preserving every advantage that a State has in every detail. That State tax rule is pretty complicated. There might be other ways to give money to States than to protect this very complex State tax.

Representative CONABLE. The whole area is pretty complicated generally, is it not, and does require some study?

Mr. BRANNON. Yes, sir.

Representative CONABLE. I wish we could get at it. The thing I think we have got to keep in mind is the necessity of freeing up capital so that we will have a more mobile capital. Our system depends on that. And this is certainly one of the rules that lead people to make foolish economic decisions for tax reasons. I agree with you completely that this is something that ought to be addressed, and we are probably not going to be generating large amounts of money, but it will have a good overall impact.

Let me ask the panel generally about social security. As has been suggested by the other testimony, social security is a compromise. I personally think we are headed for some trouble on this, because we seem to be giving benefits across the board without considering their impact fiscally, their impact on the actuarial soundness of the system, or their impact on the economy as a whole. Certainly there are many people who think of social security as a kind of a welfare system financed only from payroll taxes, when, if it were a welfare system, it obviously ought to be supported by the general taxpayer, and not on the basis of a comparatively regressive tax.

I would like you to know that a number of us on this committee have asked the chairman to hold hearings on social security, as a result of

the remarkable action of the Congress last month in putting a 20 percent benefit increase without any responsible committee of the Congress considering it at all. It is obvious that we are going to have to decide what the philosophy of our social security system in the future is going to be.

Now, is there some general feeling in the panel that if social security benefits continue to rise as they have—and in recent history we have had dramatic raises in social security benefits—that they should be taxed so as to recover some of the proceeds to the Government? This is a sensitive political problem. It has the potential of eliminating the old age retirement credit, which is a terribly complicating factor on the tax return, intended to balance tax per social security which everyone doesn't receive. Is there some sentiment generally that we should make them subject to income tax if the benefits continue to rise, and thus become a major factor in the economic income of elderly people, some of whom may have additional sources of income of some dimension?

How about it, Mr. Harriss?

Mr. HARRISS. Yes; I would think so. The portion which is in excess of the earnings on which the employee has paid tax during his working years, it seems to me, ought to be included in income for computing personal income tax.

Representative CONABLE. And the others feel that way also, do they?

Mr. OTT. Yes; I think generally our feeling is that conceptually it should be taxed like any other form of retirement income—to the extent that it exceeds capital contributed.

Representative CONABLE. You have listened to a lot of discussions of this over in the Ways and Means Committee. Are you aware of anything more than political problems in taxing social security. It is a very sensitive issue, obviously. I am foolish politically even to ask about it. I do not favor it but I suspect some of those pushing for increased benefits do.

Mr. BRANNON. In about 1966 the administration came up with a proposal that would substitute a fairly generous aged deduction for the exemption of social security, and for the retirement income credit. The thing was structured so that up to the extent of the then maximum social security, people would not lose any exemption unless their income got up over $12,000, and then some of this generous exemption was phased out. I think some of the difficulty was simply with lack of understanding, that a lot of mail started coming in along the lines, you mean you are going to tax my social security? People didn't realize that for most of the aged the situation would be considerably better.

Since then the maximum social security has gone up quite a bit. And it will certainly go up in the future as wages go up.

It would be worthwhile to make some change in this area. It is, I think, an important change. And it does require that somehow we get across the message to the public that what we are talking about is the total tax benefit to the aged, not just somehow wrecking the social security system.

Could I go back briefly to something you said earlier, when you commented about social security, and relate this to what Professor Ott said, that it is the case that our social security system is partly a welfare system and partly an insurance system.

To see that a little more clearly you might think of the minimum benefit, plus the fact that in our social security law we have what is called a bend formula for computing benefits. The ratio of the primary benefit to the average wage is higher for something like the first hundred dollars of average monthly wage, and lower thereafter. Now, to the extent of these two things, the minimum benefit, and the bend formula, it is quite conspicuous that social security is generating a benefit for the poor aged person in excess of what he paid for. In effect the minimum benefit said, if you haven't paid for at least this much, we will give it to you. And the bend formula says, we will give you more than you paid for on these basic wages. Now, I think that is a good idea. Poor old people are hard put to make ends meet. But in effect the system says that this generosity to poor old people will be financed only by middle income workers. A simple way to achieve the sort of thing, the point we are getting at, would be to separate out these extra benefits, such as the additional cost of the minimum, and this bend formula, and say that this much ought to be paid for by the whole society, not just by the first $10,000 of wages. It is just a distribution for poor people, and it would make sense to impose the burden on all income.

Representative CONABLE. I wish to point out that people who are getting small social security payments aren't necessarily poor people.

Mr. BRANNON. I agree.

Representative CONABLE. That is, the minimum benefits, in some cases, a wealthy person, because that person has had scant relation to the employment situation.

Representative REUSS. Mrs. Griffiths.

Representative GRIFFITHS. Fifty-two percent of those getting the minimum are getting a Federal pension or a municipal or some other types of pension.

I would like to speak first with the Otts on the demogrant. He realizes that there will be a few problems with the tax structure. It isn't half the problem that we have today. Today I am going to put in the record a situation of a couple in Georgia drawing $1,800 in social security. Because they are drawing $1,800 they are entitled to $300 from old age assistance. Since they are entitled to old age assistance they are entitled to a medicaid card. Because they are entitled to a medicaid card, Georgia will pay $5.60 a month to cover them under part B medicaid. Because they are entitled to old age assistance they are also entitled to $174 annually in commodities.

Now, look at what the social security 20 percent increase does to them. They will now be drawing $2,160. They lose the old age assistance of $300. They lose the $5.60 a month coverage on part B. They lose the medicaid, which could amount to $60 a month. And they lose the $174 of commodities. If some way could be figured out to give them, not $360, but just enough so that they have $2,099, so they can draw $1 of welfare, they would be entitled to all these other payments.

Now, that is what I call a really complicated system. You have to amend everything to correct it. So that to amend the tax law would be comparatively simple. And then you could also put in a lot of other little luscious things that people like in the tax law when you amend it, which is what we really do. So that it isn't really any more complicated, do you think, than amending those other things?

Mr. OTT. Madam Congresswoman, I would say that the proposal such as those we have been seeing could result in great simplicity, I think that is their great virtue.

Representative GRIFFITHS. It is practically the simplest way.

Mr. OTT. I agree, it is the simplest way. And my only point is, the numbers that people have been talking about, assuming that we can do all these things in loophole closing that we have been talking about doing—and I just want to express the appropriate skepticism about whether you can do it using those numbers, whether it is realistic to do. I agree with your point. I think that implicitly we can try to make the point another way. We should not just look at what the tax system is doing to the distribution of the income, we should look, as you just pointed out, at what all our other Federal expenditure programs are doing to the distribution of income. And the way we structure so many of them, as you point out, they are horribly tied together.

Representative GRIFFITHS. Ridiculous.

Mr. OTT. So that a dollar of increased benefits can mean a thousand dollar reduction.

Representative GRIFFITHS. Sure. Just $1 of welfare can mean a thousand dollars, or the lack of $1 and you lose a thousand dollars. It seems to me that the negative income tax would operate just—it might have some real inequities in it too.

For instance, during the last tax reform one of the persons that bothered me much that he used over and over was Mrs. Dodge in Detroit, who was getting some $2 million, it now appears, tax free each year. She would have been entitled to anything you were going to pay out under a negative income, so you might as well pass it out to everybody in the first place, because it would have created such inequities. And this would have been true of a lot of people who are beating the income tax. All of that 124 would be entitled to get something from the negative income tax. If you are going to do it that way you might as well give it to everybody and make it as fair as possible to start with.

I would like to ask you, what, if you recall, does income tax bring to the Treasury each year, Mr. Brannon?

Mr. BRANNON. Just working from memory, I think the number is about $6 or $7 billion.

Representative GRIFFITHS. It is surprising to me that most of these reformers have never been willing to mention that.

Mr. BRANNON. Well, one way to think about that $6 or $7 billion is that in the upper brackets most income is on joint returns. So that in a practical sense when you say, eliminate income splitting, you are saying that you want a higher surtax schedule to apply to most taxpayers. So effectively, it is a considerable rate increase. You could think of getting to somewhat the same result by just outright increasing the rates and providing more relief for single taxpayers.

Representative GRIFFITHS. But the last time the Kerns committee—and I wasn't present—what they really did when they tried to provide relief for single income taxpayers were couples, both of whom were working. And I am not for that either. What we are saying is that the tax laws and welfare laws of this country are such that it is better if you are single. You may be living together, but don't get married. That is really what we are saying to everybody.

Mr. BRANNON. And another part of that problem is the difficulty of community property, and just what we can do in those community property States.

Representative GRIFFITHS. I don't think the Federal Government has ever had any trouble overriding the State law.

Mr. BRANNON. There are court decisions that go the other way in this.

Representative GRIFFITHS. Maybe you could get a stronger court sometimes.

I would like to ask you, Mr. Harriss, a question to which we haven't addressed much attention. Yesterday we had a lot of discussion on the number of corporations in this country who made very good returns and paid nothing. Now, part of the worry, I think, of everybody is that those corporations go abroad, and they sell the goods that they make back here, but they don't pay taxes to any extent on those sales abroad, for all practical purposes, at least. The only thing that bothers me about that is: If you don't let them go abroad, America is going to be out of business, it seems to me.

What do you think we could do to make a more equitable situation?

Mr. HARRISS. I am not sure about the most appropriate taxation of international business. However, it seems to me that American businesses operating in the world are going to have to compete with companies operating under widely different conditions. The tax credit, I have always felt, is a reasonably effective way of achieving competitive equality so far as taxes are concerned abroad. When the income comes back to this country, let the beneficiaries of the income pay tax on it as individuals. I do not see why there should be another corporate income tax on income which is somewhere taxed up to our 48-percent rate, or whatever the rate is. If the tax credit creates an incentive which is undesirable for capital to move out of this country abroad—and I do not see how it would—then maybe the solution is a lower tax rate in this country. But I recognize that that is an unrealistic response at the moment.

I wish I had a clearer answer to what is an important question. I have not studied it. Mrs. Musgrave will testify tomorrow. She has studied this problem. To me it seems that the tax credit system, so far as this problem is concerned, yields a better result than any alternative I can see.

Representative GRIFFITHS. Do you support her theory of just letting the tax they pay be treated as a business expense and deduct it or not?

Mr. HARRISS. No; I think the credit is better. The analogy with State taxes in this country is not appropriate. The State tax is a deduction. But for international business the conditions are different.

Representative GRIFFITHS. I think that there is going to be increasing concern about this problem, and increasing pressure. But I don't see how we can run in America under our situation and compete against foreign-made goods where the government pays for all the property and you operate at one-tenth the labor cost or one-third the labor cost, and the government pays for the housing, and so forth and so on. So I think we have to do something to help our own, or we are going to be out of business.

Mr. HARRISS. This is a suggestion that deserves the best of thought that we can give it. And I can only suggest that the tax laws should

not make things worse so far as the competitiveness of American business is concerned. There is a great deal in comparative advantage.

Representative GRIFFITHS. Thank you very much.

Thank you, Mr. Reuss.

Representative REUSS. Yesterday, Congressman Vanik testified before the committee to the effect that many very profitable corporations have been paying either no corporate income tax or paying at very low rates. For example, he testified that about 20 percent of the top 100 corporations, from the standpoint of profits, either pay no taxes or pay less than 10 percent. Let me ask a number of questions addressed to any member of the panel who cares to answer them.

1. Do these surprisingly low effective tax rates for large corporations surprise you?

2. How do you account for the large variance in the effective rates paid? For example, a number of capital-intensive firms like General Motors have quite high tax rates. Other capital intensive firms like U.S. Steel, which likewise gets the benefit of the investment credit, pay at a much lower rate. Why this large variation?

3. There seems to be a special variation in the effective rate paid by banks. For example, the First National City Corp. and the Western Bank Corp. consistently paid about 10 percent less in taxes than most other large banks. Why is this so?

Can anybody offer us any enlightenment on this surprising revelation?

Mr. BRANNON. You should keep in mind the point that Congressman Vanik made yesterday in presenting these figures. They are based on what he referred to as the 10-carat reports to the Securities and Exchange Commission. It is essentially the public statement that corporations make on their experience.

Now, these statements do not have to follow tax accounting. A very common difference is that corporations in their statements to stockholders will report depreciation on the straitline basis, and frequently with a longer life than they used for tax purpose. The Congress knew about this when we were going through the ADR argument last year, that is, many of the corporations, even prior to last year, were telling the stockholders that the depreciation is not really as much as we are being allowed on the Federal tax return, but the Federal Government wants us to take more depreciation as an investment incentive, so that they take as much depreciation as we can on the tax return, and then for tax purposes they may show up with a zero income.

On this 10-carat report, which Congressman Vanik said specifically tended to overstate income in many cases, and make things look good for the stock price, the lower depreciation is reported, and you get a profit. And then you get the contrast of a profit for book purposes and a deficit for tax purposes, or no tax.

There are some other essentially accounting difficulties because of the way in which foreign and domestic taxes are reported. A company could come out with zero profits on its domestic operations, have a positive profit on its foreign operations and its overall operations, but on the foreign operation, the foreign tax might be as high as the U.S. tax, so its U.S. tax is wiped out by a tax credit, and it shows, then, in this total report that they submit for SEC purposes that they had a positive

profit, and no U.S. tax. That is an aspect of the foreign tax credit; we say there will be no additional U.S. tax in the foreign tax on that income is as high as the U.S. tax, and if there is no profit on the U.S. business, the U.S. tax, then, will be zero.

So that it is results of this sort, plus the situation of many companies not having profits in a particular year—even a large company can find themselves going badly. It might be interesting, of the total corporations, about 40 percent or more come out with no tax, because essentially they have no profits. Mr. Vanik's figures were conspicuously lower for large companies. But it is really very hard to know just how to evaluate things.

Representative REUSS. Mr. Harriss.

Mr. HARRISS. May I add just one or two comments.

First, as to the question of surprise, I was a little surprised. But no quantification would be realistic. Some businesses do use "two sets of books"—if one wants to use that phrase—perhaps quite properly. I am inclined to think that in some cases if there is a defect, it is the overstatement "true" earnings for stockholder purposes, for financial reporting. As I say in my paper, in view of inflation, depreciation may be substantially understated, probably for both purposes. Where businesses use straight line and historical costs for book purposes and reporting, the misstatement of earnings can be serious.

Some of the differences reported by Representative Vanik would be attributable to a difference in the amounts of municipal bond interest and the 85-percent exclusion of dividends. The amount of loss carryovers would make a difference. In some cases, of course, depreciation is a factor. Some of the differences are attributable to capital gains.

It is unfortunate that the kind of figures that were submitted to you yesterday get the headlines. They do so without the caveats in the footnotes. The implications that will be drawn, especially in a political year, and in an antibusiness climate, are certainly unfortunate. Perhaps something could be done to alter that situation.

Mr. OTT. Mr. Chairman, there is nothing I can add essentially to the technical details that have been presented. I think they account for most of the differences. I tend to think, though, that more than anything these results are a reflection of the fact that because we have a corporate income tax, we have to set up all sorts of arbitrary rules to try to define what corporate income is for tax purposes. To follow up the argument we tried to make in our paper, one of the greatest steps in saving resources I think we could take is to tax that income to people, which is where it ends up somehow anyway, rather than to corporations, because then we get away from all these fictitious definitions of depreciation expenses and other items in defining corporate income. And we get away from comparisons like this which are very difficult to evaluate, because we don't know really, for each corporation, except for tax purposes and stockholder reporting, what the economic depreciation is. But I submit, if they weren't taxed, that they would take depreciation that to them is economic depreciation, and that the dividends paid to stockholders and the capital gains on the corporate stock would be the true reflection in that case of what corporate income really was; otherwise, we never know really what it is.

Representative REUSS. Well, it presents an interesting problem for the public relations departments of those corporations. From some of the testimony here, what they are going to have to say to the world is, "Look, we really haven't been evading our income tax, we have been just kidding our stockholders," and it would be hard to say that in an edifying manner. But I will bet they can do it.

Mr. Conable.

Representative CONABLE. Thank you.

I think this whole discussion points up why tax reform is such a lovely political issue. It means different things to different people. One of the great problems we have is that we are dealing with two goals for our tax system when we talk about tax reform. One is greater equity. The other is greater credibility. Here in Congress we are forced to deal with this issue in terms of symbols to a certain extent. And so the corporation that doesn't pay any income tax becomes a symbol whether or not it should—from an equitable standpoint there may be a very good explanation, but from a credibility standpoint, the explanation is irrelevant if the bulk of the American people feel that the system is not fair.

Now, this raises the question, in dealing with tax reform, whether we shouldn't put increasing emphasis on simplicity, with the economy we have got nowadays, and the historical growth of the Internal Revenue Code, our system is inevitably a terribly complicated thing. And I heard one figure the other day that something like $500 million was paid last year for the preparation of tax returns. That is a hidden tax of some dimension. It reflects, I think, on the credibility of the system to have it so complicated.

So in your view as experts, where can we simplify most easily without damaging equity? And thus how can we improve the credibility of the system without creating problems of equity? Would your answer be doing away with the long-term capital gains rate? Roughly 90 percent of the work done by lawyers and tax accountants is to try to convert ordinary income into long-term capital gains. Would it be the elimination of the corporate income tax and the kind of subchapter "S" covering all corporations so that people who own stock would pay a tax on the earnings of the corporation regardless of whether or not they were plowed back into the business? Which sorts of things do you think would make the most sense dealing with a tax system that has to be equitable in a political climate? Would all of you address that question?

Mr. BRANNON. The simplicity is certainly one of the most difficult goals to talk about in tax policy. If I could go back to the notion that I tried to express in this statement today, if you think of the special tax provisions as equivalent to expenditure programs, I thing an implication is that they are not going to be simple. That is, if you want to use the tax simply to encourage mining, you are going to have to have a lot of rules dealing with what is eligible for this encouragement, and you would find that you would have similar complications if you introduced any other program to encourage mining, as to how to distinguish what is mining and what is not mining. If you want to use the tax system to encourage charitable contributions, you are going to have to have complex rules as to what is encouraged, and you will have those same rules whether you have an expenditure program to encourage charities or a tax program.

To some extent what we speak of as a complication in the tax law is the normal kind of administrative overhead which is associated with achieving a nonrevenue objective. If you are willing to give up nonrevenue objective, if we were willing to say that we will tax mining income the same way as we tax any other income, a lot of these problems disappear.

Representative CONABLE. That is a lovely thought, sir. But if I may interrupt, the very people most strongly advocating tax reform are daily presenting a proliferation of tax credit and tax preference bills for purposes which they deem to be laudable, and therefore to be tax preferences rather than loopholes.

Mr. BRANNON. So that is going to make the system more complex. But as I say, it is a difficult tradeoff between these other objectives and simplification. And it does seem, if one looks at the history of tax debates, that people talk a lot about simplicity in the tax laws, but they don't really believe it, they would rather do these other things. I regret that this is the way we feel about it.

Representative CONABLE. Your answer, then, is to throw up your hands?

Mr. BRANNON. You keep struggling. To the extent that you can cut out some of these nonrevenue objectives, you can improve, but it is going to be a very tough job.

Mr. HARRISS. So far as the personal income tax is concerned, the increase in the standard deduction moves a great deal in this direction for large numbers of taxpayers. Some probably do have to calculate using both the alternatives. Nevertheless, for masses of taxpayers, the standard deduction, which sacrifices some equity, does provide the alternative of simplicity. Beyond that, let us widen the tax brackets—with the objective of reducing the big differences in tax rates, so that so much does not hang on taxes. Perhaps the most feasible way to reduce big differences in applicable tax rates would be to widen the tax brackets. Merely to undo the effects of inflation in narrowing the purchasing power of brackets would accomplish a great deal.

As far as the corporations are concerned, once having gotten a wide range of special provisions, to repeal them or to remove them would be extremely difficult. The reduction of the rates would make it possible to achieve a lot of things, and ideally get rid of a lot of the corporation tax. But this is not a realistic alternative today. When you come to the estate and gift tax, this is a whole morass of complexities that need to be studied.

And we have gotten rid of a lot of another kind of complexity in the excise tax system.

We just cannot expect to undo the effects of a full generation of rising tax rates, of rising burdens, and of attempts for various reasons to create special situations.

Representative CONABLE. One problem, though, is that as this system becomes more and more complicated, that in itself has an impact on the credibility of the system?

Mr. HARRISS. Yes; it certainly does.

And may I add one point. Representative Vanik was suggesting that the difference between large and small corporations is their ability to take advantage of special provisions. This is probably true. The costs of taking advantage of these "opportunities" probably work to the dis-

advantage of relatively small enterprises—in some cases, but perhaps not all.

Representative CONABLE. Mr. Ott.

Mr. OTT. I think we have made a major point. I think we can see as a major hope for simplification the whole corporate income tax area. And what I would suggest is that as a separate tax it be eliminated, that the tax revenue raised thereby be raised through the individual income tax, where it is raised anyway—we just don't see where it is coming from, that is the problem. And if you stop and think about the implications of their——

Representative CONABLE. What you are saying there is that you never really tax a corporation, all you do is increase its cost of doing business, and therefore the ones who deal with corporations are the ones who ultimately pay the taxes corporations pay.

Mr. OTT. I think there has been a great dispute in the profession about who pays the corporation income tax. And one of the great arguments against it is, we have had a dispute over who is paying it. I hate to have a tax where we can't determine where the burdens lie. And that is one of my great objections to it. So what I am suggesting is that if you did not have a corporate income tax, if you did not have all the complicated administrative paraphernalia and apparatus that go with it to try to determine what corporate income tax is, and you didn't have thousands of accountants and tax lawyers trying to go through this operation, and if you taxed corporate income as it accrued to people in the form of dividends and accrued gains on their corporate stock, which is an accurate indication of what the corporate income is, you would, at least in the case of publicly traded corporations, greatly simplify the tax system.

Now, there is a problem—in other words, what I am saying is, you mentioned subchapter S as a possible alternative. And I have had problems with that, because I think you essentially don't achieve a great deal there, because you still face the problem of defining what is the income of the subchapter S corporation, even though the income is taxed to the stockholders, you still have to define what it is. And as long as you have got that problem, you are going to have the problem of a massive complication of the tax system, and massive resources being devoted to trying to define it in such a way to get the best deal for the corporation.

So I am saying, the simple thing to do is simply eliminate that as a separate tax, and tax that income, tax corporate income when it appears in the accounts of individuals, as they receive it, dividends when they receive dividends they have received corporate income, and when their corporate stock rises in value, whether they realize it or not, they are implicitly receiving corporate income.

So I see that as a very simple way of taxing corporate income.

Representative CONABLE. That certainly would have, however, an adverse effect on the accumulation of capital, wouldn't it?

Mr. OTT. I can't see why. I think the effect would be the opposite, as far the allocation of resources. If you think of corporate income as now being taxed more heavily than income from other sources, removing the corporate tax will, to the extent that you get a reallocation of capital in the economy in the corporate and noncorporate sectors, improve the allocation of resources. That is the whole point.

If I may repeat a point we have made in the paper, it is just as bad on equity grounds, it seems to me, to have a tax which taxes one kind of income more heavily—it is just as bad to do that as it is to give preference to a form of income, if you are talking about equity between people. So why should a person with income from corporate capital pay a higher tax than other persons with the same income from noncapital sources? So there is an equity argument as well as a very major resource allocation argument for elimination of the corporate income. And I can see that as providing a major simplification.

I will have to agree with the other gentlemen who have spoken that as far as the individual income tax is concerned, I think you raise the question of equity versus simplification. If you go down it provision by provision, you do run into many cases in which the two are compatible. I think equity and simplification are compatible in the area of State and local bond interest, for example. I think in other areas, however, trying to be equitable means less simplification rather than more. And it is not a problem that is easy when one gets to the individual income taxes. However, I repeat, I think there are a number of provisions where we can accomplish the same thing in a simpler way.

Representative CONABLE. Obviously, we have not historically put in the code complications, exemptions, and exceptions for the purpose of being less equitable.

Mr. HARRISS. May I add a point?

The more that I think about the problems of depreciation, the more I realize that this country is going to be around a long time, then 1 year as against another may not make so much difference as used to seem important. The tax-free loan to business from accelerated depreciation has validity. Greater freedom as regards depreciation would simplify. In talking the other day with the tax man of a big corporation, I learned that they are hoping soon to get final actions on return of the early 1960's. What has held them up? Depreciation, controversy over depreciation. In the long run might it not be better to make even less attempt to allocate depreciation to 1 year as against another for tax purposes. Let businesses choose. And perhaps require them to use the same for purposes of reporting income to shareholders. It may very well be desirable to give up attempts to put so much on the decisions for 1 year as against another in capital consumption allowances.

Representative CONABLE. I have one last question of the Otts.

Mr. Ott, you said that municipal bonds were considered by many people to be marginal investments, and therefore that they tended to carry a greater burden of the cyclical pattern of tight money than other investments. I am just a little skeptical about that. I think many people consider municipal bonds preferred investments—not just Mrs. Griffiths' friend, Mrs. Dodge—but many other people also consider municipal bonds to be a very desirable type of investment, because of our increasing tax orientation. Have you made studies that indicate that it is the least desired type of long-term fixed return investment?

Mr. OTT. Congressman, I am sorry, I think I garbled that point in trying to get it out. It related to banks. That is, the commercial banks are a large factor in the State and local bond market. For many banks the conventional wisdom is—and I am not sure that this has really been

studied carefully, but this is the conventional wisdom on the subject—that they use State and local bonds as marginal investments. First they take care of their prime loan customers, the business firms. And when money gets tight they cut off their lending in the State and local bond market, in order to maintain their good relations with their prime borrowers. So it is marginal from the point of view of the most important sector investing in State and local American bonds, commercial banks.

Representative CONABLE. You will be interested to know that when we were working with this in the Tax Reform Act of 1969, we wanted to impose in the Ways and Means Committee a minimum tax. And while we were considering this, as I recall, the bottom fell out of the muncipal bond market, because businessmen, bankers in particular, can live with almost any ruling you can make as long as it is a fairly reasonable rule, but they won't move during times of uncertainty, and the result was, nobody was buying municipal bonds then. I guess a lot of these bonds lost value, and they sold them at reduced prices, and set off their losses against their gains, reducing their income.

And the tax revenues from bank income taxes went down substantially during that particular year as a result of our having considered imposing a minimum tax on municipal bonds.

It is an interesting sidelight on the discussion of the tax reforms.

Mr. OTT. May I say one other thing?

As a sidelight to Congresswoman Griffiths' example—and now again we are referring to poor old Mrs. Dodge—my understanding is that last year she passed away. I have been attempting to find a substitute. But I want to point out that we are going to find us another Mrs. Dodge for the purposes of illustration.

Representative CONABLE. She is one of the symbols we deal with here.

Mr. OTT. Yes; we lost a symbol.

Mr. BRANNON. Could I make a comment?

On the experience in 1969, I think a great deal of that uncertainty was that the proposed minimum tax business would have gone to outstanding bonds. It is essentially a transition problem. If you really wanted to change the treatment of exempt interest in a meaningful way and applied new rules to future issues, that kind of great uncertainty that we ran into would not arise.

And if I could, I would like to call the committee's attention to an excellent addition to this argument in the Ott paper on the tax subsidy volume. In analyzing the allocation effects of this exempt interest, they show that it does tend to distort State and local decisions to have a rule that their interest costs get a special benefit, that their other costs do not get. If you think of a school system going through a careful piece of cost-benefit analysis as to what is the best way to improve this school, to add some new rooms, or to get better teachers, they could come out to a point where these alternatives were really quite comparable in real payoff. But it turns out that the Federal Government reduces the cost of adding the rooms through exempt interest. But it doesn't do this on other kinds of current outlays you make. So that basically there is a lot of distortion arising from this interest on which the Otts have given the committee some useful analysis.

Representative REUSS. You members of the panel have been most helpful, and we appreciate it. Thank you Mr. Brannon, Mr. Harriss, and Mr. and Mrs. Ott.

We will now stand recessed until 10 o'clock tomorrow morning in this room.

(Whereupon, at 12:20 p.m., the committee was recessed until 10 a.m., Friday, July 21, 1972.)

TAX SUBSIDIES AND TAX REFORM

FRIDAY, JULY 21, 1972

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10:10 a.m., in room 1202, New Senate Office Building, Hon. Henry S. Reuss (member of the committee) presiding.

Present: Representatives Reuss, Conable, and Brown.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; John R. Karlik and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; Walter B. Laessig, minority counsel; and Leslie J. Bander, minority economist.

OPENING STATEMENT OF REPRESENTATIVE REUSS

Representative REUSS. Good morning.

The Joint Economic Committee will be in order for a continuation of its hearings on tax reform.

Our first witness is an old friend, Mr. Edwin S. Cohen, Under Secretary of the Treasury. He is a lawyer and teacher as well, and has been a member of the council of the Advisory Group on Corporate Taxes of the House Ways and Means Committee, and has taken part in numerous studies of taxation.

Mr. Cohen will appear alone. And following him there will be a panel consisting of three. Prof. Edward Erickson of North Carolina University was a consultant on the Capitol Task Force on Oil Imports, U.S. Treasury, of the Office of Economic Opportunity. Another panel member will be Prof. Wassily W. Leontief of Harvard, a former president of the American Economic Association, and father of the input-output concept, and one of the country's leading economists.

And Mrs. Peggy Musgrave, who is professor of economics of Northeastern University, and an expert on public finance and national economics, and is the author of "U.S. Taxation and Foreign Investment Income."

Secretary Cohen, we are delighted to have you with us. You have a comprehensive prepared statement with appendixes which under the rule and without objection will be received in full. And we would like to have you now proceed in your own way without any particular time limit.

STATEMENT OF HON. EDWIN S. COHEN, UNDER SECRETARY OF THE TREASURY

Mr. COHEN. Thank you, Mr. Chairman. I am very pleased to have the opportunity to appear before you today to participate in your consideration of the Federal tax structure.

The President has stated that he will submit to the Congress for action next year recommendations for further tax reform. Chairman Mills of the Committee on Ways and Means and Chairman Long of the Committee on Finance, as well as numerous members of both committees, have also stated that further tax reform legislation will be taken up next year. The Treasury is conducting a thorough review of the tax law in preparation for this legislation.

The Tax Reform Act of 1969, on which the administration and the Congress collaborated throughout almost the entire year 1969, was a landmark in the long history of tax legislation. Together with the Revenue Act of 1971, it represented a major achievement in improving the equity and efficiency of the tax structure.

The President's recommendation for the low-income allowance adopted by the Congress in 1969 and updated in 1971, has removed from the Federal income tax rolls substantially all citizens whose incomes are below the poverty level. For single persons, the minimum income level at which the tax applies has been raised from $900 in 1969 to $2,050 in 1972. For a family of four, it has been raised from $3,000 in 1969 to $4,300 in 1972. These changes mark a major advance in the equity of the income tax structure.

At the other end of the income scale, much has been said in the heat of a political campaign year to indicate that the rich somehow manage to avoid paying income taxes. In the face of political rhetoric, it is important that we keep a proper perspective and consider the need for further reform of the tax structure with a calm and deliberate appraisal.

It is true that a small number of taxpayers with high "adjusted gross income" showed no net "taxable income" on their tax returns for 1970. But if we look at the data as a whole it is clear that persons with high adjusted gross incomes are paying heavy Federal income taxes. The preliminary statistics of income for 1970—and our final statistics will be available in a few weeks—are shown in table 1 of my prepared statement.

I shall not try to read the table, Mr. Chairman, but you will notice two of the five lines that I have commented on. When three persons out of a group of 624 with adjusted gross income above $1 million pay no tax, it is pertinent to inquire why this might occur. But in making the inquiry, one should not lose sight of the fact that 621 of this group paid an average tax of about $985,000, for a total of $612 million. This represented an effective tax of 46.4 percent of their adjusted gross income and 65.3 percent of their net taxable income.

Similarly, for the 15,323 with adjusted gross incomes above $200,000, the data shows 112 persons paying no tax, but it shows that 15,211 persons paid an average tax of $177,161, for a total of $2.7 billion. This represented an effective tax of 44.1 percent of their adjusted gross income and 59.5 percent of their taxable income.

We should be slow to condemn a Federal income tax system that produces by voluntary assessment these huge amounts of tax on high ad-

justed gross income groups merely because a fraction of 1 percent of the cases report no tax due.

I might add, Mr. Chairman, that late yesterday afternoon I saw some of the first runs from the computer model of the 1970 tax returns, which is just becoming operational. This involves the minimum tax, which some persons have said has been largely ineffective but which appears to have been quite effective in some cases. The computer run reflected the case of one individual who paid no regular income tax but a minimum tax of over $600,000. At least for that individual the minimum tax enacted in 1969 had a substantial impact.

It is important also to note that the information as to taxable and nontaxable persons is preliminary data taken from returns as filed and prior to audit by the Internal Revenue Service. A review of many of the returns indicates that on audit taxes may be found to be due.

The Treasury Department and the Joint Committee on Internal Revenue Taxation have reviewed the returns showing no tax filed by the 112 persons with adjusted gross incomes above $200,000, and I am attaching to my prepared statement letters that I have written to Congressman Conable and to you, Congressman Reuss, concerning our analysis of the returns, together with a brief discussion of them in a speech that I gave on April 29, 1972.

I shall not read the comments about these cases that I have in my prepared statement, in the interest of time. But as I pointed out in my letter to you that is attached as an appendix to my prepared statement, it will be seen that—

> Some of these individuals paid high income taxes abroad, which are credited against U.S. tax to avoid double taxation;
>
> Some of them paid very high U.S. taxes for 1969 and paid their State income taxes in 1970 on their high 1969 income. On the cash basis of accounting used by most individuals, the high 1969 State income taxes paid in 1970 exceeded their 1970 incomes and eliminated their 1970 Federal tax liability. This is merely a result of the cash basis of accounting and is not a recurring circumstance; and
>
> Many of them had high deductions for interest paid. There are indications that some of these may owe minimum tax for 1970 on audit of the returns. Moreover, the 1969 act will have the effect, starting January 1, 1972, of disallowing interest deductions that substantially exceed investment income. To the extent that the interest paid offsets investment income, we should consider revising the definition of "adjusted gross income" to require that the interest be deducted in computing adjusted gross income rather than being treated as a personal deduction.

And I make a similar point with respect to certain miscellaneous deductions claimed as business bad debts, business litigation payments; and the expenses of deriving income.

I think we may find that we need to revise the definition of adjusted gross income to take those amounts into account in the determination of adjusted, gross income.

In table 2 of my prepared statement are shown the results of the changes that have been made since January 1969 in the tax laws and regulations. As the table shows, the income tax burden has been reduced in the zero to $3,000 income class by 82 percent, and has been reduced in gradually decreasing percentages in each higher income class to the $50,000 to $100,000 level. But in the income level above $100,000 the liability has been raised 7.4 percent.

It has sometimes been charged that the tax laws and regulations since the beginning of 1969 have favored corporations as against individuals. This is not so, in our judgment. I set forth here the date

with respect to the four calendar years 1969–72, the current calendar year 1972, and an estimate of the 12-year span from 1969 through 1980. I think it is fair to infer from this that the changes that have been made since the beginning of January 1969 have not preferred corporations as against individuals. Substantially all the reductions have gone to individuals. I think we should bear those circumstances in mind as we prepare for another thorough review of the income tax and entire Federal tax structure.

Now, Mr. Chairman, the Joint Economic Committee published on January 11, 1972, an extensive staff study entitled "The Economics of Federal Subsidy Programs." Included in that study was an analysis of what was called tax subsidies. The data for this was taken primarily from a letter dated May 11, 1971, from former Assistant Secretary Weidenbaum to Chairman Proxmire giving revenue cost estimates for the fiscal years ended June 30, 1970 and 1971, prepared by the Treasury staff, of certain items in the tax structure selected by the staff of the Joint Economic Committee. The letter appears as appendix A of the committee staff study, at pages 205–206.

I am attaching hereto as appendix D to my prepared statement a schedule showing similar estimates for these same items for the calendar year 1971, which would correspond to the fiscal year 1972. (The figures for fiscal years 1970 and 1971 in Mr. Weidenbaum's letter represented estimates for calendar years 1969 and 1970.) There are also included estimates as to several additional items which the committee staff included in the list that appears in the committee staff study at page 31.

In addition, as you requested, I am attaching as appendix E to my prepared statement our preliminary figures as to the breakdown of these estimates to indicate their effect on individual tax liabilities by adjusted gross income categories.

I should say as a word of caution that with respect to a number of items in the list these estimates are difficult to prepare and involve substantial uncertainties because of lack of information concerning them on tax returns.

In my prepared statement, Mr. Chairman, I illustrate this, and I point out that we are in the process of preparing, in consultation with the staff of the Joint Committee on Internal Revenue Taxation, a more detailed report with respect to these matters, as was agreed in the conference report under the Revenue Act of 1971. The report is to be made to the Joint Committee on Internal Revenue Taxation, the House Committee on Ways and Means, and the Senate Committee on Finance, and we shall be pleased to furnish the Joint Economic Committee with a copy of that report when it is completed.

As Mr. Weidenbaum noted in his letter, "There is considerable conceptual controversy as to what is and what is not a tax subsidy." The Treasury is pleased to furnish to the congressional committees estimates as to the revenue effect of various aspects of the tax law on which the committees wish information. Yet the characterization of particular items as subsidies, the exclusion of other items from the list, and the economic and net revenue and budgetary effects of changing or repealing these items are all matters on which there is extensive division of opinion.

In particular, while it is desirable that this information be available for public scrutiny and analysis, we should bear in mind its shortcomings. I will not go through all of the difficulties outlined in my prepared statement in detail, Mr. Chairman, but I will just enumerate them. If you want to, we can discuss them later. Consider the following:

First, the estimate for each item is made on the assumption that it would be eliminated without any other changes in the law, if you assume that you are going to make more than one change. The result of the several changes being made concurrently could provide greater or less revenue effect from the sum of the changes calculated independently of each other.

Second, the estimates assume no change in tax rates, personal exemptions or the minimum standard deduction. If you made extensive amounts of these changes, undoubtedly you would want to change tax rates or personal exemptions or the minimum standard deduction.

Third, in the estimates, no offset is made for the cost of substitute programs that would doubtless be enacted to replace some of the tax provisions if they were terminated. I illustrate this point with reference to State and local bond interest, and the provisions relating to housing.

Fourth, the estimates have been prepared on the basis of the so-called first level effects, without any offset for the "feedback" increases in revenue that now flow from the increased investment and economic activity that many of the present provisions generate.

Fifth, if these provisions were changed, there would probably be effective date provisions which would make the revenue effect in many instances small initially and build up over a period of time. I understand that Professor Brannon made this point before the committee yesterday.

Sixth, the Federal tax law includes not only provisions that cause a reduction in tax that arguably are "subsidies" but also other provisions that increase the tax burden and affect its distribution, some of which arguably are "penalties." These offsetting items should be taken into account.

And I list several illustrations. For example:

The list includes the additional tax that would be due if capital gains were treated as ordinary income. But there is a penalty involved in existing law in the provision that net capital losses can be deducted by individuals only against $1,000 of ordinary income annually and no deduction for net capital losses can be taken by corporations. If capital gains were to be treated as ordinary income, should capital losses be treated as ordinary deductions and allowed in full against ordinary income? If so, since taxpayers might choose to realize their capital losses and defer realization of their capital gain, there could be an actual loss in revenue.

The income tax on corporations, estimated now at a level of some $36 billion, is in reality borne by individuals, either by the shareholders of the corporations or by consumers of their products and services. Economists and others differ as to the extent to which the corporate tax burden is passed forward to consumers or backward to shareholders. I am attaching as appendix F to my prepared state-

ment an estimate as to the distribution of the burden by income classes based on five different assumptions as to the extent of the division of the corporate tax burden between consumers and shareholders. If the corporate tax is assumed to be shifted forward, it is in essence an excise tax on consumers and bears heavily on low- and middle-income-level individuals; if it is assumed to be borne by shareholders, the estimates show that it increases substantially the income tax burden on upper income level individuals.

The estate and gift tax, as well as other Federal taxes, represent additional burdens that are not taken into account in the attached list. They have a significant effect upon the distribution of the tax burden.

The income tax rate structure itself can be said to involve a "penalty" to one group or another depending upon their points of view; for it affects differently single persons, married couples, heads of households and surviving spouses, as well as affecting differently low-income, middle-income, or high-income groups.

These are merely illustrations of difficulties involved in considering the effects of the provisions which the committee staff has selected as "tax subsidies." Again let me say that I think it highly desirable that these matters be publicly reviewed and debated, but the review and the debate should take into account the many different problems that in combination make solutions so difficult to find. There are no easy answers.

Each issue of tax policy is encased in a long history, with plentiful arguments on either side. Many of them are not included in the committee staff's list. All of them are deserving of a thorough review in the Congress in 1972, as should be done periodically. The changes made in 1969 and 1971 represented a major overhaul of the tax system to improve its equity and its efficiency. More remains to be done. But in the process of review, let us not forget that, whatever its problems, our Federal income tax system has been the most efficient revenue device in the history of the world. As we constantly strive to improve it, we must proceed with calm analysis and thoughtful judgment of the complex issues.

Thank you, Mr. Reuss.

(The prepared statement, with appendixes, of Mr. Cohen follows:)

PREPARED STATEMENT OF HON. EDWIN S. COHEN

Mr. Chairman and members of the committee: I am pleased to have the opportunity to appear before you today to participate in your consideration of the federal tax structure.

The President has stated that he will submit to the Congress for action next year recommendations for further tax reform. Chairman Mills of the Committee on Ways and Means and Chairman Long of the Committee on Finance, as well as numerous members of both committees, have also stated that further tax reform legislation will be taken up next year. The Treasury is conducting a thorough review of the tax law in preparation for this legislation.

The Tax Reform Act of 1969, on which the Administration and the Congress collaborated throughout almost the entire year 1969, was a landmark in the long history of tax legislation. Together with the Revenue Act of 1971, it represented a major achievement in improving the equity and efficiency of the tax structure.

The President's recommendation for the Low Income Allowance, adopted by the Congress in 1969 and updated in 1971, has removed from the federal income tax rolls substantially all citizens whose incomes are below the poverty level. For single persons the minimum income level at which the tax applies has been raised

from $900 in 1969 to $2,050 in 1972. For a family of four it has been raised from $3,000 in 1969 to $4,300 in 1972. These changes mark a major advance in the equity of the income tax structure.

At the other end of the income scale, much has been said in the heat of a political campaign year to indicate that the rich somehow manage to avoid paying income taxes. In the face of political rhetoric, it is important that we keep a proper perspective and consider the need for further reform of the tax structure with a calm and deliberate appraisal.

It is true that a small number of taxpayers with high "adjusted gross income" showed no net "taxable income" on their tax returns for 1970. But if we look at the data as a whole it is clear that persons with high adjusted gross incomes are paying heavy federal income taxes. The Preliminary Statistics of Income for 1970 show the following:

TABLE 1

Adjusted gross income class	Total number of returns	Number showing no tax	Number showing tax due	Average tax paid
Over $1,000,000	624	3	621	$984,862
Over $500,000	2,393	22	2,371	483,089
Over $200,000	15,323	112	15,211	177,161
Over $100,000	77,899	394	77,505	73,678
Over $50,000	429,568	1,338	428,230	28,886

When three persons out of a group of 624 with adjusted gross income above $1,000,000 pay no tax, it is pertinent to inquire why this might occur. But in making the inquiry, one should not lose sight of the fact that 621 of this group paid an average tax of about $985,000, for a total of $612 million. This represented an effective tax of 46.4 percent of their adjusted gross income and 65.3 percent of their net taxable income.

Similarly, for the 15,323 with adjusted gross incomes above $200,000, the data shows 112 persons paying no tax, but it shows that 15,211 persons paid an average tax of $177,161, for a total of $2.7 billion. This represented an effective tax of 44.1 percent of their adjusted gross income and 59.5 percent of their taxable income.

We should be slow to condemn a federal income tax system that produces by voluntary assessment these huge amounts of tax on high adjusted gross income groups merely because a fraction of one percent of the cases report no tax due.

It is important also to note that this is preliminary data taken from returns as filed and prior to audit by the Internal Revenue Service. A review of many of the returns indicates that on audit taxes may be found to be due.

The Treasury Department and the Joint Committee on Internal Revenue Taxation have reviewed the returns showing no tax filed by the 112[1] persons with adjusted gross incomes above $200,000, and I am attaching to my statement letters that I have written to Congressmen Conable and Reuss concerning our analysis of the returns, together with a brief discussion of them in a speech that I gave on April 29, 1972 (Appendices A, B and C). From these analyses it will be seen that—

Some of these paid high income taxes abroad which are credited against U.S. tax to avoid double taxation.

Some of them paid very high U.S. taxes for 1969 and paid their state income taxes in 1970 on their high 1969 income. On the cash basis of accounting used by most individuals, the high 1969 state income taxes paid in 1970 exceeded their 1970 incomes and eliminated their 1970 federal tax liability. This is merely a result of the cash basis of accounting and is not a recurring circumstance.

Many of them had high deductions for interest paid. There are indications that some of these may owe minimum tax for 1970 on audit of the returns. Moreover, the 1969 Act will have the effect, starting January 1, 1972, of disallowing interest deductions that substantially exceed investment income. To the extent that the interest paid offsets investment income,

[1] As explained in my letters to Congressmen Conable and Reuss, attached as Appendices B and C hereto, examination of the returns later showed that there were 106 nontaxable returns involved that were governed by the Tax Reform Act of 1969.

we should consider revising the definition of "adjusted gross income" to require that the interest be deducted in computing adjusted gross income rather than being treated as a personal deduction.

Some of them had large miscellaneous deductions claimed as business bad debts, business litigation payments, and expenses of deriving income, which—if they are allowed on audit—again might better be classified as reducing adjusted gross income rather than being treated as a personal deduction. In other words, if these deductions are properly taken as expenses of earning business or investment income and make the persons nontaxable, those persons ought not really be classed as "high income" persons merely because they have high gross income and incur high expenses in earning that income, since the income tax is properly levied only on net income.

I do not intend by these observations about the nontaxable returns to indicate that further reform is not in order. I mean only to stress that substantially all those with high adjusted gross income are paying heavy amounts of taxes and that the few nontaxable cases, while requiring analysis and review, should not distract us from a proper appraisal of the overall system.

Indeed, we should be careful to note that the changes made since January 1, 1969 have produced a significant shift in the distribution of the federal income tax on individuals, reducing the burden in the lower income levels and raising it in the higher, as shown in the table below:

TABLE 2.—EFFECT ON INDIVIDUAL INCOME TAX LIABILITY OF TAX REFORM ACT OF 1969, ADR AND THE REVENUE ACT OF 1971, FULL-YEAR EFFECT AT CALENDAR YEAR 1971 LEVELS OF INCOME

[Dollar amounts in millions]

Adjusted gross income class	Tax under 1968 law [1]	Tax under 1972 law	Change under 1972 law from 1968 law	
			Amount	Percent
0 to $3,000	$1,469	$265	−$1,204	−82.0
$3,000 to $5,000	3,488	1,995	−1,493	−42.8
$5,000 to $7,000	5,543	4,025	−1,518	−27.4
$7,000 to $10,000	12,263	10,112	−2,151	−17.5
$10,000 to $15,000	22,065	19,202	−2,863	−13.0
$15,000 to $20,000	15,687	13,891	−5,396	−9.1
$20,000 to $50,000	19,375	18,377	−998	−5.2
$50,000 to $100,000	7,344	7,217	−127	−1.7
$100,000 and over	7,131	7,658	+527	+7.4
Total	93,965	82,743	−11,222	−11.9

[1] Excluding surcharge.

As will be seen from this table, the income tax burden has been reduced in the zero to $3,000 income class by 82 percent, and has been reduced in gradually decreasing percentages in each higher income class to the $50,000 to $100,000 level. But in the income level above $100,000 the liability has been raised 7.4 percent.

It has sometimes been charged that the tax laws and regulations since the beginning of 1969 have favored corporations as against individuals. This is not so. Treasury estimates show that the combined effect of changes in the law and regulations since January 1, 1969 have had the following effect:

For *the four calendar years 1969–1972* they will have: increased corporate income taxes by an aggregate of $4.9 billion; decreased individual income taxes by an aggregate of $18.9 billion; and decreased excise taxes on automobiles and telephones, mostly affecting individuals, by $3.5 billion.

For *the current calendar year 1972* they will have: decreased corporate income taxes by $0.4 billion; decreased individual income taxes by $12.0 billion; and decreased excise taxes by $2.6 billion.

For the *12-year span from 1969 through 1980*, assuming economic growth, they will have: decreased corporate income taxes by an aggregate of $8.1 billion, an average of $0.7 billion a year; decreased individual income taxes by an aggregate of $140.7 billion, an average of about $11.7 billion a year; and decreased excise taxes by $19.7 billion, an average of about $1.6 billion a year.

It is clear that the changes have not preferred corporations as against individuals. Substantially all the reductions have gone to individuals.

These circumstances should be borne in mind as we prepare for another thorough review of the federal tax structure.

The Joint Economic Committee published on January 11, 1972 an extensive staff study entitled "The Economics of Federal Subsidy Programs." Included in that study was an analysis of what was called "tax subsidies." The data for this was taken primarily from a letter dated May 11, 1971 from former Assistant Secretary Weidenbaum to Chairman Proxmire giving revenue cost estimates for the fiscal years ended June 30, 1970 and 1971, prepared by the Treasury staff, of certain items in the tax structure selected by the staff of the Joint Economic Committee. The letter appears as Appendix A of the Committee staff study, at pages 205–206.

I am attaching hereto as Appendix D a schedule showing similar estimates for these same items for the calendar year 1971, which would correspond to the fiscal year 1972. (The figures for fiscal years 1970 and 1971 in Mr. Weidenbaum's letter represented estimates for calendar years 1969 and 1970.) There are also included estimates as to several additional items which the Committee staff included in the list that appears in the Committee staff study at page 31.

In addition, as you requested, I am attaching as Appendix E our preliminary figures as to the breakdown of these estimates to indicate their effect on individual tax liabilities by adjusted gross income categories.

I should say as a word of caution that with respect to a number of items in the list these estimates are difficult to prepare and involve substantial uncertainties because of lack of information concerning them on tax returns. As an illustration, tax-exempt state and local bond interest is not reported on tax returns, and the estimates must be prepared from other sources which themselves are open to some question. When the data is not available on tax returns, the breakdown between income classes presents special uncertainties. We are continuing to do further work to improve these estimates.

We are in the process of preparing, in consultation with the staff of the Joint Committee on Internal Revenue Taxation, a more detailed report with respect to these matters, as was agreed in the conference report on the Revenue Act of 1971.

The report is to be made to the Joint Committee on Internal Revenue Taxation, the House Committee on Ways and Means and the Senate Committee on Finance, and we shall be pleased to furnish the Joint Economic Committee with a copy of that report when it is completed.

As Mr. Weidenbaum noted in his letter, "there is considerable conceptual controversy as to what is and what is not a tax subsidy." The Treasury is pleased to furnish to the Congressional committees estimates as to the revenue effect of various aspects of the tax law on which the committees wish information. Yet the characterization of particular items as subsidies, the exclusion of other items from the list, and the economic and net revenue and budgetary effects of changing or repealing these items are all matters on which there is extensive division of opinion.[2]

In particular, while it is desirable that this information be available for public scrutiny and analysis, we should bear in mind its shortcomings. Among the difficulties, to list a few, are the following:

1. Estimate for each item is made on the assumption that it would be eliminated without any other changes in the law. Thus if two or more items were changed, the result of the several changes being made concurrently could produce greater or less revenue effect than the sum of the changes calculated independently of each other. Thus an addition of the separate estimates may not produce meaningful figures.

2. The estimates assume no change in tax rates, personal exemptions or the minimum standard deduction. The serious economic effects of terminating or changing these various provisions of existing law without a basic change in the rate structure, for example, have not been taken into account in making the estimates. The changes would affect investment patterns and activity. One cannot assume, therefore, that termination of these provisions would raise the revenue indicated by each item.

3. In the estimates, no offset is made for the cost of substitute programs that would doubtless be enacted to replace some of the tax provisions if they were terminated. For example, with respect to the exemption for state and local bond

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[2] See, e.g., the criticism in Bittker, *Accounting for Federal "Tax Subsidies" in the National Budget*, XXII National Tax Journal 244 and the reply in Surrey and Hellmuth, *The Tax Expenditure Budget-Response to Professor Bittker*, XXII National Tax Journal 528.

interest, the cost of federal payments to offset the increased cost of taxable state and local bonds has not been reflected; nor, for example, has any provision been made for the cost of substitute programs that might be needed with respect to housing if the tax provisions relating to housing were changed. In many instances there doubtless would be no net revenue gain from a change.

4. The estimates have been prepared on the basis of the so-called "first level" effects, without any offset for the "feedback" increases in revenue that now flow from the increased investment and economic activity that many of the present provisions generate.

5. If various existing provisions were changed, the statutory changes in many instances would contain effective date provisions that would apply only to subsequent investments or activity occurring after the date of the change and not to investments and commitments previously made. Thus the revenue effect in many instances would be small initially and would require a number of years to reach the amounts indicated.

6. The federal tax law includes not only provisions that cause a reduction in tax that arguably are "subsidies" but also other provisions that increase the tax burden and affect its distribution, some of which arguably are "penalties." These offsetting items should be taken into account.

AS ILLUSTRATIONS

The list includes the additional tax that would be due if capital gains were treated as ordinary income. But there is a penalty involved in existing law in the provision that net capital losses can be deducted by individuals only against $1,000 of ordinary income annually and no deduction for net capital losses can be taken by corporations. If capital gains were to be treated as ordinary income, should capital losses be treated as ordinary deductions and allowed in full against ordinary income? If so, since taxpayers might choose to realize their capital losses and defer realization of their capital gain, there could be an actual loss in revenue.

The income tax on corporations, estimated now at a level of some $36 billion, is in reality borne by individuals, either by the shareholders of the corporations or by consumers of their products and services. Economists and others differ as to the extent to which the corporate tax burden is passed forward to consumers or backward to shareholders. I am attaching as Appendix F an estimate as to the distribution of the burden by income classes based on five different assumptions as to the extent of the division of the corporate tax burden between consumers and shareholders. If the corporate tax is assumed to be shifted forward, it is in essence an excise tax on consumers and bears heavily on low and middle income level individuals; if it is assumed to be borne by shareholders, the estimates show that it increases substantially the income tax burden on upper income level individuals.

The estate and gift tax, as well as other federal taxes, represent additional burdens that are not taken into account in the attached list. They have a significant effect upon the distribution of the tax burden.

The income tax rate structure itself can be said to involve a "penalty" to one group or another depending upon their points of view; for it affects differently single persons, married couples, heads of households and surviving spouses, as well as affecting differently low-income, middle-income or high-income groups.

These are merely illustrations of difficulties involved in considering the effects of the provisions which the committee staff has selected as "tax subsidies." Again let me say that I think it highly desirable that these matters be publicly reviewed and debated, but the review and the debate should take into account the many different problems that in combination make solutions so difficult to find. There are no easy answers.

Each issue of tax policy is encased in a long history, with plentiful arguments on either side. Many of them are not included in the committee staff's list. All of them are deserving of a thorough review in the Congress in 1973, as should be done periodically. The changes made in 1969 and 1971 represented a major overhaul of the tax system to improve its equity and its efficiency. More remains to be done. But in the process of review, let us not forget that, whatever its problems, our federal income tax system has been the most efficient revenue device in the history of the world. As we constantly strive to improve it, we must proceed with calm analysis and thoughtful judgment of the complex issues.

Appendix A

Excerpt From Remarks of Edwin S. Cohen

PERSONS WITH HIGH ADJUSTED GROSS INCOME

Much has been said recently about the fact that about 100 individuals in the United States in 1970 had "adjusted gross incomes" about $200,000 without paying any tax. Some have argued that this handful of cases shows that the system is unfair and that rich do not pay taxes. I shall talk further about those few cases in a moment.

But I do not think we should let that small group of individuals obscure the fact that, according to our preliminary data, there were in 1970 a total of some 15,300 persons in the country with adjusted gross incomes above $200,000, and that some 15,200 of them paid an average federal individual income tax of $177,000 each—a total of some $2.7 billion. This is an effective rate of 44.1 percent of their adjusted gross income and 59.5 percent of their taxable income.

From this it is perfectly clear that in general the rich are paying federal income taxes in large amounts. And they are paying more than they were in 1968 while other taxpayers are paying less.

Let me now refer to the cases of the few nontaxable persons with adjusted gross income above $200,000. The statistical data now shows that there were 106 such persons. The number of these nontaxable persons was down from 300 in 1969. The adjusted gross income on these 106 returns was less than 17 percent of that on the 300 returns in 1969.

We have now done some further analysis of these returns and have classified them according to the five principal causes of nontaxability: foreign tax credit, deductions for taxes paid, deductions for charitable contributions, deductions for interest payments, and miscellaneous deductions.

As to the seven cases in which nontaxability was due primarily to the foreign tax credit, it is interesting to note that these seven taxpayers paid income tax to foreign countries of about $1.5 million, an average of more than $200,000 tax per taxpayer. This represented an effective foreign income tax rate of 62 percent of their adjusted gross income and 70 percent of their taxable income. It is clear that while these individuals were not required to pay U.S. income tax, they were subjected to heavy income taxes abroad.

Another group of 12 individuals whose adjusted gross income aggregated $4.1 million, paid no 1970 federal income tax because their deductions for state and local taxes exceeded $4.1 million. Substantially all these deductions were for state income taxes. A review of these returns suggested that these individuals had large amounts of nonrecurring income in 1969 on which they paid substantial state income taxes in the spring of 1970, which were deductible on their 1970 federal income tax returns. To check out this hypothesis, we have now obtained data as to the 1969 federal income tax returns of 11 of these 12 individuals and have found that the 11 persons paid 1969 federal income tax totalling about $18 million, an average of more than $1.6 million of tax per individual. The fact that they paid no federal tax for 1970 after paying huge taxes for 1969 is simply a result of the cash basis of accounting which is used by most individuals, and the fact that the state taxes on their large 1969 income were paid in the spring of 1970. To change the tax laws to overcome this result for these dozen individuals would produce undue complexities and require additional expense for many thousands or millions of other taxpayers. This would not be worth the effort. No tax system can achieve perfection, certainly not without incredible complexities and expense.

Another 12 cases involved individuals with adjusted gross income of $8.5 million whose principal deductions consisted of charitable contributions aggregating $4.2 million. The 1969 Act terminated the "unlimited charitable contribution deduction" provision of prior law and set the contribution deduction limit at 50 percent of adjusted gross income. It was recognized that if charitably inclined individuals can deduct their contributions up to one-half of their adjusted gross income, there will necessarily be a few cases in which other deductions for interest, taxes, medical expense, etc., will exceed the other half of adjusted gross income and result in nontaxability.

In 55 of the cases interest paid was the principal deduction, aggregating $17.3 million. But in these returns dividends and interest received aggregated $16.5

million. In general, when interest is paid to borrow money needed to make investments on which dividends and interest income is received, the interest paid should be charged against the interest and dividends received and only the net profit should be reflected in adjusted gross income. If a man pays interest in his business, only the net profit goes into adjusted gross income. But for simplicity's sake, the tax law for many years has said that where this occurs in an investment situation, the gross dividend and interest income is reflected in his adjusted gross income—and makes him appear on the surface to be in a high income category—while the offsetting interest expense that he incurs is classed as a personal deduction along with taxes, charitable contributions, casualty losses, alimony, etc. Possibly we should change the definition of "adjusted gross income" so that net investment income is treated like net business income.

There are, however, some cases in this group in which the interest paid exceeds the investment income by substantial amounts. In these cases, as well as some others, there are indications that the minimum tax may be due for 1970 and may be assessed on audit. For 1972 and subsequent years, investment interest paid that exceeds by more than $25,000 the taxpayer's investment income may be disallowed as a deduction under the 1969 Tax Reform Act.

The final category consists of 20 cases in which the principal deduction was miscellaneous deductions, aggregating $10.5 million. Of this total, more than $5.5 million represents items described in the returns generally as loss of securities pledged to secure loans, losses on guarantees of loans, and payments in settlement of litigation. Another $2.2 million of miscellaneous deductions represents an aggregate of accounting, bookkeeping and professional fees, and investment counsel and management fees. If these items are properly deductible—and this can only be determined after audit—it is because they represent expenses of earning business or investment income and may indicate that we should change the definition of "adjusted gross income" to drop these people out of the high income category.

To illustrate, consider one of the returns that reported as the only income more than $400,000 of gambling gains and reported an equal amount as gambling losses under miscellaneous deductions, for a net income of zero. This return, too, will be audited; but if the return stands up under audit, we might consider levying an amusement tax, but the income tax is supposed to apply only to the successful gamblers.

Now I do not mean to imply from this review of the 106 cases that there is not a constant need for vigilance and improvement in the tax laws. Most assuredly there is a definite need. I mean only to indicate that there is relatively little guidance to be gained from these particular returns in relation to major issues of tax policy, and the attention that has been devoted to them is unwarranted and unwise.

APPENDIX B

ASSISTANT SECRETARY,
DEPARTMENT OF THE TREASURY,
Washington, D.C., MARCH 1, 1972.

Hon. BARBER B. CONABLE,
House of Representatives, Washington, D.C.

DEAR MR. CONABLE: In response to your request, I am writing to set forth the information that we have developed to date with respect to individuals with adjusted gross incomes above $200,000 for the year 1970 who showed no income tax due on their federal income tax returns for that year.

The information that there were 112 such individuals came from computer runs made from preliminary data extracted for statistical purposes in connection with the customary preparation by the Internal Revenue Service of its Statistics of Income series. The data is derived from a sample of some 500,000 of the approximately 75,000,000 individual income tax returns. The sample includes all returns filed that show adjusted gross income above $200,000, and the information extracted from each return and fed into the computer shows, among numerous items, the amount of adjusted gross income reported and the federal income tax shown on the return to be payable. It is thus a routine matter, as a part of other analyses of data, to run the computer to identify the number of returns with adjusted gross income above $200,000 which reported no tax due.

This statistical data is preliminary, however, and is customarily reviewed before publication of final data for the year.

Moreover, I should point out that this data is taken from the returns as filed by the taxpayers before audit of the returns by the Internal Revenue Service. I understand that at least 58 of these returns are already under audit by the Service or have been assigned for audit. We have now received in the Treasury copies of all the returns, and it appears likely that tax will be collected on a number of the returns after audit.

The Tax Reform Act of 1969 took effect, in general, as of January 1, 1970, although some of its provisions become effective gradually over a period of years. It is significant to note, therefore, that—

(a) There was a substantial decrease between 1969 and 1970 in the number of nontaxable returns with adjusted gross income above $200,000—from 300 to 112.

(b) The percentage which those 112 nontaxable returns bore to the total number of returns with adjusted gross income above $200,000 dropped from 1.6% in 1969 to 0.7% in 1970. (There were some 18,000 returns with adjusted gross incomes above $200,000 in 1969 and some 15,000 in 1970.)

(c) The total adjusted gross income on nontaxable returns with adjusted gross income above $200.000 dropped from $279 million to $46 million, less than 17% of the 1969 total.

(d) The number of nontaxable returns with adjusted gross income above $1.000,000 dropped from 52 in 1969 to 3 in 1970.

Of the 112 returns listed preliminarily, examination of copies of the returns show that inadvertently 8 were erroneously so classified:

Paid a "minimum tax" under 1969 act	2
Paid income tax under Sec. 962 (permitting individuals under certain circumstances to pay corporate income tax instead of individual income tax on certain types of foreign income)	1
Delinquent returns for prior year (not subject to 1969 act)	3
Returns with net operating loss carried over from prior year	1
Duplicate return	1
Total	8

Of the remaining 104 returns, 6 returns paid substantial income tax to foreign countries, mostly on salaries, for which credit is allowable against U.S. income tax.

On the remaining 98 returns, the principal deduction against adjusted gross income resulting in no tax was as follows:

State income tax 12

Review of the returns before audit indicates that this is likely due to payments in 1970 by cash basis taxpayers of state income tax for 1969 or prior years. For example, a person having a large capital gain or other non-recurring income in 1969 generally can pay the state income tax on that 1969 income when he files his state return for 1969 in the spring of 1970, in which event that state tax is deductible on the cash basis of accounting in his 1970 federal income tax return. The state tax on large non-recurring 1969 income may offset all or a substantial part of the taxpayer's lower 1970 income.

Also, if on audit of his state returns for prior years the taxpayer paid additional state taxes for those years in 1970, he might have a very substantial deduction for state taxes in 1970. It is also possible that he could have paid in 1970 state taxes on 1970 income that is not subject to federal income tax, such as interest on state and local bonds, but it does not seem from a review of the copies of the returns that the large deductions were caused by that circumstance.

Charitable contributions 13

Only 2 of these returns showed contributions above the 50% maximum generally permitted, and one of these was a return for a fiscal year ending in 1970, which was not subject to the 1969 Act. In 1966 there were 49 nontaxable returns with adjusted gross income above $200,000 that took the "unlimited" charitable contribution deduction, which was ended by the 1969 Act.

Interest expense 54

In many cases interest is incurred as an expense of borrowing money for investments which produce current ordinary income. If the interest paid is high in relation to the income received, this may result in returns showing high adjusted gross income but no net taxable income; this may reflect simply a failure by the taxpayer to earn a net profit on his investment, as in the case of a business that borrows money, pays interest to its creditors, and has no net profit after paying the interest.

Where the taxpayer's interest paid substantially exceeds his investment income, however, the 1969 Act included the excess among the preferences subject to the minimum tax for the years 1970 and 1971; and indications are that as a result of that provision in the 1969 Act, a number of these returns will be subjected to the minimum tax on audit. For 1972 and subsequent years, investment interest paid that exceeds by more than $25,000 the taxpayer's investment income will generally be disallowed under the Tax Reform Act of 1969.

Some of the interest claimed as personal deductions on the 1970 returns may properly be classed as business items, but the interest deduction was shown by the taxpayer as a non-business item on his return. The place at which the interest deduction was reflected on the return might be immaterial if no tax is due.

Miscellaneous deductions:		
Loss of securities pledged as collateral for loans		3
Gambling losses		1
(Gambling losses are deductible against gambling gains; this return merely reports miscellaneous gambling income above $400,000 and a deduction for an identical amount of miscellaneous gambling losses for the year.)		
Investment expense other than interest	7	
Theft casualties	2	
Sundry (bad debts; payments in settlement of litigation, etc.)	6	19
		98

A number of these deductions involve large sums and some involve unusual transactions. On audit of the returns the deductions may be disallowed or reduced or they may be treated as capital losses, which may be deducted only against $1,000 of income other than capital gains.

Respectfully yours,

EDWIN S. COHEN.

APPENDIX C

APRIL 28, 1972.

Hon. HENRY S. REUSS,
House of Representatives, Washington, D.C.

DEAR MR. REUSS: I am writing in reply to your letter of March 23, 1972. requesting further information with respect to individuals reporting adjusted gross incomes of $200.000 or more for 1970 who paid no Federal income tax for that year. As you noted, I reviewed the nature of these returns in my letter of March 1, 1972, to Congressman Barber B. Conable, Jr., which was reprinted in the Congressional Record on that day.

In your letter to me you asked if I could select a representative sampling of those returns and analyze them in the way that eleven returns of high income individuals were analyzed in the 1968 "Tax Reform Studies and Proposals" (pp. 89–94). This would involve summarizing various items of income, deductions and credits on the individual returns. We have given careful consideration to your request and I have reviewed it at length with Dr. Laurence N. Woodworth, Chief of Staff of the Joint Committee on Internal Revenue Taxation.

As I advised Mr. Verdier of your office, we have concluded that, even deleting the names, addresses and identification numbers of those individuals, we could not disclose the information publicly without breaching the requirements of confidentiality of tax returns. Disclosure of salary or other large items of income or deductions for the year 1970 would make it possible to identify some of the individuals from information that is either publicly available or known to other persons who were involved in transactions with those individuals; and once the individul is so identified from particular items, his other income and deductions would become known. By contrast, the cases described in the 1968 Studies by the prior administration were taken from returns filed in various years that were not identified.

Dr. Woodworth and I concluded that the best method of giving the information to you without breach of disclosure requirements was to set forth the aggregate totals for the items of income and deduction you requested for all the returns in each of the five categories referred to in my letter to Congressman Conable. Those categories were selected according to the principal item of credit or deduction that made the return nontaxable: (1) foreign tax credit; (2) taxes; (3) contributions; (4) interest and (5) miscellaneous. In addition, data includes the grand total for all five categories as a group. In each instance the data includes items you requested, as follows:

Adjusted gross income:
Amended gross income:
Wages and salaries
Dividends
Interest
Capital gains (100 percent)
Other income (net)
Total deductions:
Contributions
Interest
Taxes
Medical
Other
Taxable income?
Tax.

A schedule showing this information, prepared in a cooperative effort by the staff of the Treasury Department and the Joint Committee on Internal Revenue Taxation, is attached. Some minor changes have been required in the draft schedule that was given to you by Dr. Woodworth on April 15; first, one previously included return that had contributions as the principal deduction has been deleted because, as noted in my letter to Mr. Conable, it was a return for a fiscal year that began in 1969 and ended in 1970, and accordingly was not governed by the Tax Reform Act of 1969, which in general took effect for the first time for years beginning in 1970; and, second, three additional returns have been located. The attached schedule, therefore, includes 106 returns instead of the 104 returns previously included.

You asked that the schedules show not only "adjusted gross income" but also "amended gross income." The term "amended gross income" is not used in the tax law, but we understand that you intended it to include in addition to the above items found in adjusted gross income 100 percent instead of 50 percent of long-term capital gains, as well as tax exempt interest on state and local obligations, percentage depletion in excess of cost depletion and depreciation in excess of straight-line depreciation.

As you will notice in the schedule, we have included in the table 100 percent of capital gains, although only 50 percent are included under the Internal Revenue Code.

However, we are unable at this time to include amounts for tax exempt interest on state and local bonds because those amounts are not required to be reported on the tax returns and cannot be obtained prior to audit of the returns.

There has been included in "amended gross income" the amount of percentage depletion shown in the individual tax returns in excess of what is estimated cost depletion might have been and depreciation shown in the return in excess of estimates of straight-line depreciation.

With respect to the 12 returns in which the principal deduction was taxes paid, aggregating $4,160,000, it may be noted that of this amount $4,046,000 represented state and local income taxes paid. As I remarked in my letter to Congressman Conable, it appears likely that these large deductions were due to the fact that individual taxpayers generally file their returns on a cash basis; and these deductions seem to represent payments in 1970 on the filing of state and local income tax returns for 1969 in which large gains or income were reported. We have now obtained data as to the 1969 Federal income tax returns of 11 of these 12 individuals, and find that they paid 1969 Federal income tax totaling about $18 million, an average of more than $1.6 million of tax per individual.

With respect to returns in which miscellaneous deductions were the largest item, the aggregate of $10,371,000 in miscellaneous deductions included the following:

Loss of securities pledged to secure loans, loss on guarantees of loans, and payments in settlement of litigation	$5,510,000
Accounting, bookkeeping and professional fees, investment counsel and management fees	2,155,000
Theft and casualty losses	658,000
Other	2,193,000
Total	$10,516,000

I would emphasize, as I did in my letter to Congressman Conable, that this information has been compiled from the returns as filed without audit, that most of these returns are under audit, and that these audits may produce substantial assessments of tax. In particular, it appears that a number of the returns will be subjected to the minimum tax on audit, and that some of the miscellaneous deductions may be disallowed or reduced, or treated as capital losses which may be deducted only against $1,000 of income other than capital gains. To the extent that the interest and miscellaneous deductions are allowed on audit, it appears likely that many of them represent business and investment expenses or losses that perhaps should be deducted in computing adjusted gross income instead of being included among miscellaneous deductions.

You asked for a statement of the percentage which the tax paid on these returns bears to amended gross income and amended taxable income. Since these returns constitute a group in which no Federal income tax was paid, that percentage is necessarily rare, except to the extent that tax will prove to be due following audit of the returns. However, with respect to the seven cases in which the U.S. tax was effect in full by foreign tax paid, the taxpayers paid foreign income tax aggregating about $1.5 billion. This represented an effective foreign income tax rate of 70 percent of the U.S. taxable income and 62 percent of the U.S. adjusted gross income and U.S. amended gross income.

You also inquired as to the effective rate of tax on persons at the poverty level. Prior to the Tax Reform Act of 1969, Federal income tax was imposed on the income of single persons in excess of $900 (personal exemption of $600 plus minimum standard deduction of $300); and, in general, this minimum level was increased by $700 for each additional person included in the return (additional personal exemption of $600 plus $100 minimum standard deduction). This resulted in taxes being imposed on persons below the poverty level.

However, the President recommended in 1969 the institution of the Low Income Allowance which was incorporated in the Tax Reform Act of 1969 so as to raise the minimum level to which the income tax could be applied to approximately the then estimated poverty levels. Under the 1969 Act the minimum level of tax was to be adjusted to a small extent in the years 1971–1973. In the Revenue Act of 1971, effective for the year 1972, the minimum levels for tax were increased as follows:

Family size (up to 4)	Minimum level for tax	Estimated poverty level
1	$2,050	$2,170
2	2,800	2,810
3	3,550	3,350
4	4,300	4,290

Because of the need to have systematic increases as the size of the family increases, the minimum level of tax is sometimes somewhat below and sometimes somewhat above the estimated poverty level. For a single person in 1972 it is possible for a person to pay tax at a tax rate of 14 percent on $120 of income below the estimated poverty level of $2,170, or a tax of $16.80, an effective rate of less than one percent. A married couple could pay tax of $1.40 if their income was $2,800, which would be $10 below the estimated $2,810 poverty level—an effective tax rate of 0.05%.

Income for poverty level purposes includes so-called "transfer payments" (such as social security benefits, unemployment insurance and welfare payments) which are not included in income for tax purposes; and the poverty levels are based upon the assumption that the individual occupies his own separate household, which it has not been considered feasible to require for tax purposes. Thus while there are some minor differences between the minimum income tax level and the estimated poverty level, the general plan of the law since the 1969 Act has been to impose no Federal income tax on persons below the estimated poverty levels.

Enclosed for your convenience is a copy of my letter of March 1, 1972, to Congressman Conable.

I trust this provides the information which you requested.

Respectfully yours,

EDWIN S. COHEN.

Enclosures.

MAJOR SOURCES OF INCOME AND DEDUCTIONS FOR 106 NONTAXABLE INCOME TAX RETURNS WITH ADJUSTED GROSS INCOMES OF $200,000 OR MORE IN 1970, CLASSIFIED BY LARGEST DEDUCTION OR CREDIT [1]

[Dollar amounts in thousands]

	Income and deductions, returns for which largest deduction or credit was—					
	Foreign tax credit	Taxes paid	Charitable contributions	Interest paid	Miscellaneous deduction	Total
Number of returns	7	12	12	55	20	106
Wages and salaries	$767	$562	$372	$2,673	$1,445	$5,819
Dividends	1,015	1,700	7,506	11,402	6,525	28,148
Interest	701	2,467	1,009	5,132	1,395	10,704
Capital gains (100 percent)	2	563	108	5,132	2,466	8,271
Other income	(20)	(893)	(424)	(4,353)	533	(5,157)
Adjusted gross income	2,462	4,123	8,516	18,470	11,134	44,705
Amended gross income [2]	2,471	4,427	8,606	20,166	12,392	48,062
Contributions deductions	39	389	4,227	2,019	1,976	8,650
Interest deductions	89	416	1,327	17,337	1,261	20,430
Tax deductions	111	4,160	973	1,106	1,426	7,776
Medical deductions	(3)	29	39	74	56	198
Miscellaneous deductions	55	417	2,380	1,533	10,516	14,901
Total deductions	294	5,412	8,947	22,069	15,235	51,957
Taxable income	2,156	(3)	67	205		2,428
Ordinary tax	1,384	(3)	21	84		1,489
Minimum tax						
Foreign tax credit	1,384	(3)	7	84		1,475
Other credits			14	(3)		14
Tax after credits						

[1] Excludes 1 fiscal-year return for which the provisions of the Tax Reform Act of 1969 were inapplicable.
[2] Adjusted gross income plus the excluded half of net long-term capital gains plus deductions for depletion and depreciation reported on the tax returns which are estimated to be in excess of deductions allowed under cost depletion and straight-line depreciation accounting methods.
[3] Less than $500.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

APPENDIX D

EFFECT OF SELECTED TAX PROVISIONS

[In millions of dollars]

	Calendar year 1971		
	Corporations	Individuals	Total
Exclusion of benefits and allowances to Armed Forces personnel		650	650
Exemption for certain income earned abroad by U.S. citizens		50	50
Exclusion of income earned by individual in U.S. possessions		10	10
Western Hemisphere trade corporations	75		75
Exclusion of gross-up on dividends of less-developed country corporations	55		55
Deferral of income of controlled foreign subsidiaries	165		165
Exclusion of income earned by corporations in U.S. possessions	80		80
Farming: Expensing and capital gain treatment	50	790	840
Timber: Capital gain treatment for certain income	125	50	175
Expensing of exploration and development costs	260	65	[1] 325
Excess of percentage over cost depletion	785	200	985
Capital gains treatment of royalties on coal and iron ore	5		5
Investment credit	1,495	305	[2] 1,800
Depreciation on buildings (other than rental housing) in excess of straight line	320	160	480
Asset depreciation range	600	100	[3] 700
Dividend exclusion		300	300
Capital gains: Corporation (other than agriculture and natural resources)	380		[4] 380
Bad debt reserves of financial institutions in excess of actual	400		[5] 400
Exemption of credit unions	40		40
Deductibility of interest on consumer credit		1,800	1,800
Expensing of research and development expenditures	545		545
$25,000 surtax exemption	2,300		2,300
Deferral of tax on shipping companies	10		10
Rail freight car amortization	45		[6] 45
Deductibility of interest on mortgages on owner-occupied homes		2,400	2,400
Deductibility of property taxes on owner-occupied homes		2,700	2,700
Depreciation on rental housing in excess of straight line	300	200	[7] 500
Housing rehabilitation	10	15	25
Disability insurance benefits		155	155
Provisions relating to aged, blind, and disabled:			
Combined cost for additional exemption, retirement income credit, and exclusion of OASDHI for aged		3,250	3,250
Additional exemption for blind		10	10
Sick pay exclusion		120	120
Exclusion of unemployment insurance benefits		800	[7] 800
Exclusion of workmen's compensation benefits		320	[7] 320
Exclusion of public assistance benefits		65	65
Net exclusion of pension contributions and earnings:			
Plans for employees		3,650	[7] 3,650
Plans for self-employed persons		250	250
Exclusion of other employee benefits:			
Premiums on group term life insurance		500	500
Deductibility of accident and death benefits		30	30
Medical insurance premiums and medical care		2,000	2,000
Privately financed supplementary unemployment benefits		5	5
Meals and lodging		170	170
Exclusion of interest on life insurance savings		1,100	1,100
Deductibility of charitable contributions (other than education)		3,200	3,200
Deductibility of medical expenses		1,900	1,900
Deductibility of child and dependent care expenses		30	[8] 30
Deductibility of casualty losses		165	[7] 165
Excess of standard deduction over minimum		700	700
Capital gains: Individuals		5,600	[4] 5,600
Pollution control amortization	15		15
Additional personal exemption for students		550	550
Deductibility of contributions to educational institutions		275	[7] 275
Exclusion of scholarships and fellowships		110	[7] 110
Exclusion of certain veterans' benefits		700	700
Exemption of interest on State and local debt	1,800	800	2,600
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes)		5,600	5,600

[1] Considered in isolation this estimate would be $800,000,000. However, if considered in conjunction with percentage depletion the $325,000,000 gives a more accurate picture of the revenue effect.

[2] Effective for only a part year in calendar year 1971. The full-year effect would be $3,300,000,000

[3] 1st-year effect, 2d-year effect would be $1,700,000,000. Thereafter builds up for a period of years.

[4] Assumes present restriction on capital losses is retained.

[5] This will decline over time as present law becomes fully effective.

[6] The estimate appears only because the investment credit is effective for only a part year. It will disappear when the investment credit is fully effective.

[7] Not comparable with previous estimates due to revised and/or new sources of data and improved estimating methods.

[8] The liberalized child care deductions which become effective in calendar year 1972 would increase the estimate to $175,000,000.

Appendix E

ESTIMATED DISTRIBUTION OF SELECTED ITEMS OF TAX PREFERENCES OF INDIVIDUALS, BY ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1971

[In millions of dollars]

Adjusted gross income class	Exclusion of benefits and allowances to Armed Forces personnel	Exemption for certain income earned abroad by U.S. citizens	Exclusion of income earned by individuals in U.S. possessions	Farming, expensing and capital gains treatment	Timber, capital gains treatment for certain income	Expensing of exploration and development costs	Excess of percentage over cost depletion	Investment credit	Depreciation on buildings (other than rental housing) in excess of straight line	Asset depreciation range	Dividend exclusion	Deductibility of interest on consumer credit
0 to $3,000	15	----------	----------	20	----------	----------	1	3	----------	----------	5	1
$3,000 to $5,000	120	1	----------	55	2	1	2	16	3	2	13	44
$5,000 to $7,000	175	4	1	80	2	3	8	27	5	4	17	64
$7,000 to $10,000	180	6	1	120	2	2	6	41	11	6	29	185
$10,000 to $15,000	115	7	2	155	4	4	12	51	18	12	55	435
$15,000 to $20,000	28	16	3	90	2	4	12	32	12	9	46	380
$20,000 to $50,000	13	15	3	170	9	16	50	73	47	37	99	620
$50,000 to $100,000	3	1	----------	55	8	14	43	33	28	23	27	59
$100,000 and over	1	----------	----------	45	21	21	66	29	36	7	9	12
Total	650	50	10	790	50	65	200	305	160	100	300	1,800

APPENDIX E—CONTINUED

ESTIMATED DISTRIBUTION OF SELECTED ITEMS OF TAX PREFERENCES OF INDIVIDUALS, BY ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1971—Continued

[In millions of dollars]

Adjusted gross income class	Deductibility of interest on mortgages on owner-occupied homes	Deductibility of property taxes on owner-occupied homes	Depreciation on rental housing in excess of straight line	Housing rehabilitation	Disability insurance benefits	Provisions relating to aged, blind, and disabled: Combined cost for additional exemption retirement income credit, and exclusion of OASDHI for aged	Provisions relating to aged, blind, and disabled: Additional exemption for blind	"Sick pay" exclusion	Exclusion of unemployment insurance benefits	Exclusion of workmen's compensation benefits	Exclusion public assistance benefits	Net exclusion of pension contributions and earnings: Plans for employees	Net exclusion of pension contributions and earnings: Plans for self-employed
0 to $3,000					35	805	1	2	65	15	25	45	
$3,000 to $5,000	27	41	4		40	750	2	13	110	28	20	145	7
$5,000 to $7,000	81	84	6	1	25	420	2	16	110	41	15	230	10
$7,000 to $10,000	276	263	14	1	20	585	2	32	185	69	5	535	13
$10,000 to $15,000	719	642	22	2	10	245	1	19	230	83		995	22
$15,000 to $20,000	543	505	15	1	5	125	1	20	65	39		685	18
$20,000 to $50,000	621	788	59	6	6	215	1	15	20	38		750	96
$50,000 to $100,000	101	240	35	3	3	70		2	5	6		175	71
$100,000 and over	32	137	45	1	1	35				1		90	13
Total	2,400	2,700	200	15	155	3,250	10	120	800	320	65	3,650	250

APPENDIX E—CONTINUED

ESTIMATED DISTRIBUTION OF SELECTED ITEMS OF TAX PREFERENCES OF INDIVIDUALS, BY ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1971—Continued

[In millions of dollars]

Adjusted gross income class	Exclusion of other employee benefits: Premiums on group life insurance	Deductibility of accident and death benefits	Medical insurance premiums and medical care	Privately financed supplementary unemployment benefits	Meals and lodging	Exclusion of interest on life insurance savings	Deductibility of charitable contributions (other than education)	Deductibility of medical expenses	Deductibility of child and dependent care expense	Deductibility of casualty losses	Excess of standard deduction over minimum
0 to $3,000	5	----------	25	----------	2	5	3	5	1	----------	10
$3,000 to $5,000	20	1	80	----------	14	20	31	100	7	5	3
$5,000 to $7,000	30	2	125	1	22	35	82	205	12	10	15
$7,000 to $10,000	75	5	300	1	35	85	225	325	5	30	100
$10,000 to $$15,000	135	8	550	2	35	205	467	470	3	40	415
$15,000 to $20,000	95	6	380	1	25	185	364	310	1	20	115
$20,000 to $50,000	105	6	415	----------	30	420	716	360	1	30	50
$50,000 to $100,000	25	1	95	----------	5	80	426	90	----------	20	2
$100,000 and over	10	1	30	----------	2	65	886	35	----------	10	----------
Total	500	30	2,000	5	170	1,100	3,200	1,900	30	165	700

APPENDIX E—CONTINUED

ESTIMATED DISTRIBUTION OF SELECTED ITEMS OF TAX PREFERENCES OF INDIVIDUALS, BY ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1971—Continued

[In millions of dollars]

Adjusted gross income class	Capital gains: Individuals	Additional personal exemption for students	Deductibility of contributions to educational institutions	Exclusion of scholarships and fellowships	Exclusion of certain veterans' benefits	Exemption of interest on State and local debt	Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes)
0 to $3,000	30	1		6	30	5	4
$3,000 to $5,000	60	17	3	26	95		56
$5,000 to $7,000	70	40	7	28	110		88
$7,000 to $10,000	150	101	20	22	130	5	361
$10,000 to $15,000	230	182	58	15	220	10	772
$15,000 to $20,000	210	92	70	10	70	20	772
$20,000 to $50,000	960	47	90	3	41	100	1,713
$50,000 to $100,000	920	54	20		3	300	906
$100,000 and over	2,970	16	7		1	360	928
Total	5,600	550	275	110	700	800	5,600

Note: Presented by the Honorable Edwin S. Cohen, Under Secretary of the Treasury, in testimony before the Joint Economic Committee, Congress of the United States, July 21, 1972.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

Appendix F

DISTRIBUTION OF THE CORPORATE INCOME TAX-BURDEN[1] ON INDIVIDUALS

[In billions of dollars]

Adjusted gross income class	Full forward shifting to consumer prices	¾ borne by consumers, ¼ borne by stockholders	½ borne by consumers, ½ borne by stockholders	¼ borne by consumers, ¾ borne by stockholders	Full tax borne by stockholders
0 to $3,000	2.8	2.8	2.8	2.7	2.7
$3,000 to $5,000	2.4	2.1	1.8	1.6	1.3
$5,000 to $7,000	2.9	2.4	2.0	1.5	1.0
$7,000 to $10,000	5.4	4.5	3.6	2.6	1.7
$10,000 to $15,000	7.5	6.3	5.2	4.0	2.8
$15,000 to $20,000	4.0	3.5	3.0	2.5	2.0
$20,000 to $50,000	3.3	4.3	5.3	6.3	7.3
$50,000 to $100,000	.7	1.7	2.6	3.6	4.6
$100,000 and over	.5	1.9	3.4	4.9	6.4
Total	29.6	29.6	29.6	29.6	29.6

[1] Net liability at calendar year 1971 levels after all credits.

Note: Items may not add to totals due to rounding.

Representative REUSS. Thank you very much, Mr. Under Secretary.

In your presentation just now, you say that much is being said in the heat of a political campaign year about people avoiding their income taxes, and I quote "In the face of political rhetoric it is important that we keep a proper perspective and consider the need for further reform of the tax structure with a calm and deliberate appraisal." I want to be calm and deliberate, as you have been, so let's look at it together.

You point out in your prepared statement that for people with adjusted gross incomes above $200,000, which number 15,323, almost all of the 15,211 paid an average tax of $177,161, and that "this represented an effective tax of 44.1 percent of their adjusted gross income, and 59.5 percent of their taxable income."

Well, that sounds reassuring to somebody who doesn't know what adjusted gross income is. But is it not a fact that adjusted gross income is one of those lovely Treasury terms which deliberately excludes the very loophole income we are talking about—capital gains, oil depletion, tax exempt bonds, interest on life insurance savings, and so on? So that these people did make millions, taken together, on which they paid no tax whatever, and this 44 percent figure merely relates to that portion of their income which wasn't loophole income, isn't that so?

Mr. COHEN. Mr. Chairman, I could not agree more that the use of adjusted gross income as a measurement here has great defects.

First, let me say that the concept of adjusted gross income is not one which is used by the Treasury in its discretion. The term adjusted gross income is found in the Internal Revenue Code. And it is used for various purposes. For example, the standard deduction, now 15 percent, is geared to adjusted gross income. The ceiling on charitable contributions deductions and the floor under medical deductions, are geared to what we call adjusted gross income. And it may be a defective concept for some of these purposes, but it is very difficult to determine what concept should be used.

If we use taxable income, and we could run the computers and publish the statistical data by taxable income classes, it would have

the same defect that you suggest. And it has been thought for many years by those who preceded me that adjusted gross income is the best measurement that we have of setting forth the data from the returns as they are now.

But I pointed out in my prepared statement that adjusted gross income is a concept that warrants reexamination.

Now, you are perfectly right in saying that adjusted gross income does not include tax exempt State and local bond interest, and is calculated after deduction of percentage depletion in excess of cost depletion. Further, it includes only 50 percent of net long-term capital gains. And all of these defects I not only agree with you on, but I would point them out in collaboration with you.

But I would point out that you asked me to give you not only adjusted gross income, but also what you called "amended gross income." If you would turn to the table that I furnished you in my letter to you of April 28, 1972, which is appendix C to my prepared statement, you will notice that we did the best that we could from the data on the returns. These individuals in the aggregate had $44.7 million of adjusted gross income, and $48 million of "amended gross income," which added back the excluded half of net long-term capital gains and also the excess of percentage depletion over cost depletion, as well as the excess of accelerated depletion over straight line depreciation. And you find that it only increased the income from $44.7 to $48 million. That is a difference of $3.3 million out of $44.7.

There may be, and undoubtedly was, more than that, because one of the difficulties we are faced with is that a lot of these deductions for percentage depletion and accelerated depletion, and so on, occur in partnership returns which we do not have available to match with the returns of the partners. The difficulty is that they are filed in different parts of the country.

Nevertheless, my point is that this group of 112 or 106 persons is not a group in which the defects in adjusted gross income that you mention, so far as we know, have caused the nonpayment of tax. There are plenty of other returns where the point you make is quite significant. There may be people who pay tax, but at not a large enough effective rate. But this group I don't think illustrates the point you make unless it is with respect to tax exempt bond interest, as to which we have no information.

Representative Reuss. Let me suggest that I don't think the real question which gets us tax reformers outraged is so much, as you suggest in your prepared statement, that the rich manage to avoid paying income taxes entirely. That gives rise to endless witty diversities about the 109 and what they actually did, which I am really not particularly interested in. What does concern me is that a great number of very well-to-do people pay a pittance in Federal income taxes while the average working person pays much more.

For example—and I don't think this is disputed—back in March, when you released your Internal Revenue Service publication 198-2-72—that was the one that related to the 18,000 wealthy people who theoretically were subject to the minimum tax, the 10 percent minimum tax—we found that the average tax they paid on their tremendous preference income was 4 percent.

Well, that is just half of what a $7,000 a year working man pays. He pays at the rate of 8 percent. Doesn't this disturb you?

Mr. COHEN. Yes, Congressman.

Representative REUSS. But there is not a word of it in your presentation. All you do is laugh off the 108 who seemingly achieved the mission impossible, escaping without paying a dime of taxes. Well, in many cases I would agree with you, there is good reason for that. But put them to one side. It is just indisputable that these 18,000, that is a lot of people, all of whom made very large incomes averaging well over $30,000 a year, paid at the effective rate of 4 percent on their preference income, whereas a $7,000-a-year worker pays at the rate of 8 percent. I don't see how we can tell our constituents that they should stop their taxpayer's revolt, that all is well, while that is going on.

Mr. COHEN. Congressman, I did not mean to indicate that all is well. I specifically said that the President has said, Chairman Mills has said, and Chairman Long has said that the time has come for a further review next year.

With respect to the minimum tax, I shall not try to defend the efficiency of the minimum tax. It was not the form of provision to deal with tax preferences that the administration recommended. It was not the one that the House of Representatives passed, after the action of the Ways and Means Committee. We suggested a limit on tax preferences that we thought was far more effective than the minimum tax that was adopted in the Senate.

This provision was rewritten on the floor of the Senate. And I do not subscribe to this rather complex provision.

Now, I think we ought to take a good hard look at it. Further, I cited in a comment, as I went through my prepared statement, a case that just came out of the computer late yesterday of an individual who paid no regular income tax, but $600,000 in minimum tax. It worked in his case. And whether it was right in his case or not is a matter on which people could disagree. But it had quite an application in that particular case.

I think it has some peculiar results, sometimes being ineffective and sometimes being perhaps too harsh.

Representative REUSS. Well, I never thought you would be capable of arousing in my bosom sorrow for the man who paid a $600,000 minimum tax. Maybe we are being too harsh with him.

But I am sure that we are being too harsh with 8 million taxpayers who have to pay through the nose, while thousands and thousands, at least 18,000, subject to mininmum income tax, make well over $30,000 a year, and pay an effective rate less than half of what a slightly over-the-poverty-level worker has to pay.

Mr. COHEN. Congressman, I don't disagree with you in your efforts and our efforts to try to make the tax law as equitable as possible. There are undoubtedly persons who take advantage of provisions in the Federal tax law which are designed to induce investments of a particular kind, or in some cases are the results of a page in history that did not go into the law intentionally.

But let me take the case of interest on State and local bonds, an extremely difficult problems. We recommended in 1969 that the Congress allocate personal deductions for charitable contributions, State and local taxes, interest payments, and so on, so that a person

would be regarded as paying part of those personal deductions out of his taxable income, and part out of his tax-exempt income, and he would not be able to deduct the part that he is paying out of his tax-exempt income. The House passed that provision, but it was deleted in the Senate, and no provision was put into law with respect to tax-exempt interest.

Now, there is plenty of argument on the other side from the standpoint of the State and local governments, and this issue has been debated in the Congress for 30 or 40 years. If I put on my professor's hat that I wore, and from which I am on a leave of absence, and view this from the standpoint of the equity of the tax system by itself, I certainly must agree that this affects the equity of the system.

If we were to change the rule, however, it also would seriously affect the State and local governments, and I think we would provide some kind of Federal subsidy for those interest payments.

If we changed the rule and made it optional with the States whether to issue taxable or tax-exempt bonds, I am not sure that we would greatly improve the equity of the system, because it would then give each issuer an option as to what to do, and they would still be in a position to offer tax-exempt bonds for those who wanted to reduce their income tax and accept the lower yield, That is just an illustration.

Another illustration is the housing problem. We induce investment in housing through the tax law. When we came in, in 1969, and reviewed the various income tax provisions, it was clear that many individuals were reducing—some were eliminating entirely—the tax liability on account of the various provisions for accelerated depreciation on housing investment. But the Congress in 1968 had just finished passing the Housing Act of 1968, which was built around the existing income tax provisions.

On the one hand, the Congress is trying to induce investors to participate in the housing with tax benefits. On the other hand, such measures affect the equity of the tax structure. It does, however, put a lot of money into housing. We are now at a level of 2.3 million housing units without regard to the mobile units. Thus, you have your choice. You can't do both. If you are going to try to give an incentive for investment in housing, then you are going to have people taking advantage of it and that is what the Congress wanted.

Now, our limit on tax preferences as we recommended it would consider all these things together and say, this is fine, you can take advantage of incentives, but not to such an extent that you don't bear at least some fair or minimum share of the cost to the Federal Government. I still believe that that is a fundamentally sound position to take, but the minimum tax doesn't work that way.

Representative REUSS. Leaving behind for a moment your academic mortar board, and putting on your Treasury gray homburg or whatever you wear——

Mr. COHEN. I might say, Mr. Chairman, that I was a little worried when I put on my professor's hat, because as such I was an employee of the State of Virginia. Thus, I may be in an inconsistent position in commenting on State and local bonds.

Representative REUSS. You state in your prepared statement, Mr. Under Secretary, that the President has stated that he will submit to the Congress for action next year recommendations for tax reform.

That certainly sounds good. But how do you reconcile that with the fact that at the hearings last year on the Economic Report I asked the Secretary of the Treasury, Mr. Connally, what the administration's attitude was on the nine or 10 leading loopholes—I mentioned them—oil or gas percentage depletion, intangible drilling expense, capital gains on property transferred at death, unified gift and estate tax, generation skipping trusts, capital gains holding period, stock options, State and local bond interest—he was militantly opposed to closing every one of those.

And then, as if that was not said from on high, just a couple of months ago Mr. Connally had Mr. Nixon down to his ranch, and they had all of the leading industrial and banking and oil interest of Texas, or at least a good share of them, at the barbecue. And at that meeting, according to the press release issued by the White House which I have, President Nixon said to this audience:

> As far as I am concerned, I strongly favor not only the present depreciation rate, but going even further than that, so we can get our plants and equipment more effective. That is why, in terms of depletion, rather than moving in the direction of reducing the depletion allowance, let us look at the fact that all the evidence now shows that we are going to have a major energy crisis. To avoid that, we have to provide incentives rather than disincentives for people to go out and explore for oil. That is why you have depletion, and the people have got to understand it.

Well, in the light of those statements, what can I tell my constituents in the event that Mr. Nixon is reelected? Is there going to be any help for the average workingman taxpayer, or is he going to continue to be confronted with the fact that even at the bottom of the working spectrum he has to pay an 8-percent effective rate, while the loophole enjoyers pay one-half of that, 4 percent? What hope can I give him?

Mr. COHEN. Mr. Reuss, I think you can give him the hope that the President, as I understand it, at a press conference at which I was not present, but which was also reported in the papers more recently than the one you refer to, has specifically stated that he will present to the Congress recommendations with respect to tax reform. I do not have the statement before me. But it was made at the press conference within the last month.

Now, as I understand it—though again I was not present at the Texas statement—he took a position there with respect to incentives for oil and gas, and with respect to investment in plant and equipment, and there is nothing inconsistent in taking that position with the position that he is going to recommend changes and tax reform in the Internal Revenue Code. Those are only two items in the list of 40-some that are under investigation by this committee.

Representative REUSS. Would you consider a national sales tax like the value added tax tax reform, would that satisfy the commitment to recommend tax reform?

Mr. COHEN. You are asking me about political and governmental decisions to be made at a level above mine, Mr. Chairman, as I am sure you realize. All I know is that I am hard at work, and our staff is hard at work, in a review of the Federal tax structure from stem to stern, these are my instructions from Secretary Shultz. And I understand that we are to review the structure throughout.

Now, what decisions will be made as to what recommendations are forthcoming are naturally going to be the decision primarily of the

President and Secretary Shultz. And I assume that I will participate in those discussions, but naturally I just have my responsibilities at my level, and I can't tell you what the decisions would be.

With respect to the value-added tax or a sales tax, or whatever form of expenditure tax or consumption tax might be considered, the Treasury has considered this problem, as I understand it, for some 30 years, and the President has asked the Advisory Commission on Intergovernmental Relations to make a report to him with respect to the advisability of using a value-added tax, a sales tax, or any other form of tax in conjunction with the need to improve the property tax, particularly in relation to meeting the cost of education.

You are aware of the court decisions that will require, if those cases are sustained, some change in the property taxes in relation to education. That matter is under study by the ACIR.

Representative REUSS. Then your answer would be that, speaking for yourself, and just as a matter of philosophical definition, the value added tax could be comprised under the general rubric of tax reform?

Mr. COHEN. It certainly could be an item for consideration and it is used, as I am sure you know, to a very large extent in European nations. We have problems with respect to border tax adjustments in our exports and imports, and the difference between value added taxes and corporate income taxes and individual income taxes, so it is not possible to ignore that as a general subject.

But I would assure you that the staff of the Treasury is engaged full time in a review of the tax law from stem to stern.

Representative REUSS. The Treasury has been, I would assume, reviewing those tax laws for the last 3 years since 1969. Have you got anything to report to us this morning, any improvements, closing a loophole or two, any break for the average wage earner, any good news?

Mr. COHEN. Mr. Chairman, the 1969 act was passed at the end of 1969. And one of our major concerns in the 2 years since has been the development of regulations under that act. We published what we estimate roughly at 8,500 pages of regulations under that act. We are trying at full speed to get available the data showing the effect of the 1969 act. We are just in the process of getting operational the computer models of the 1969 returns and the 1970 returns, and in the process of updating those for economic data for 1972 and 1973.

Now, we do not yet have the computer data, the statistical data from corporation returns for 1970. So, it is not yet possible to measure the effect of the 1969 act on corporations until we have that data. But that data will be available within the next few weeks.

Now, we are making, as I indicated to you, this full review, and the President will make the recommendations to the Congress, as he said, for action next year. I think it would be inappropriate and presumptuous of me to indicate what those recommendations are, because at this stage I don't know, and even if I did, they should be made by him, and not by me.

Representative REUSS. That is entirely proper. And we can expect those Presidential recommendations, then, in the next few weeks?

Mr. COHEN. No, that is not what the President said. The President said that he would have his recommendations, according to my recollection of the press conference, by the end of the year.

Representative REUSS. Not before the election?

Mr. COHEN. My recollection of this is that he said by the end of the year. I would assume that that would mean in time for congressional action next year. This may mean the latter part of December or in his budget message or State of the Union message—assuming, of course, his reelection.

Representative REUSS. You couldn't induce him to accelerate that date? I was just thinking that the average working taxpayer might get a better break if the Presidential recommendations came before the election than after. Is that a thought forbidden under the rule of calm and deliberate appraisal that you and I have adopted?

Mr. COHEN. I would think, Mr. Chairman, that, recognizing the tight schedule of the Congress and the matters that are pending before the committees that require action between now and the close of the Congress, it is pretty clear that there is no opportunity for tax legislation this year.

I would think it unwise to try a complete review of the tax laws under those circumstances at this particular juncture of the election campaign. I think Mr. Mills and Senator Long have both so stated. And those are, as you well understand, matters that will be in the jurisdiction of the Ways and Means Committee and the Finance Committee.

Representative REUSS. Turning to another point you made earlier, Mr. Under Secretary, you stated that tax changes since 1969, have by no means helped or preferred corporations as against individuals.

Let me ask you this question.

Is it not a fact that the revenues yielded by the corporate income tax in 1969, were some 20 percent of total Federal revenues, and that the percentage will decline to something like 16 percent in this year, 1973? In other words, that the corporate income tax has declined in its revenue-raising proportion?

Mr. COHEN. Mr. Chairman, may I make two comments in relation to that.

One, if you compare one year's tax with another year's tax, there is a great difference in corporate profits in one year as compared to corporate profits in another year. I don't at the moment know the relationship of corporate profits in 1969, to corporate profits—did you say in 1971?

But obviously the corporation income tax, whatever the changes, will vary according to corporate profits. And corporate profits, as I understand, dropped in relation to gross national product.

Now, the second point that I would make is that social security taxes and benefits are constantly rising, and they are assuming a larger and larger proportion of the total budget. I take it you are using unified budget figures. Therefore as social security taxes go up and benefits go up, they force downward the percentage of all the other taxes in the total revenue.

I understand from a brief summary that Mr. and Mrs. Ott referred to this circumstance in their testimony yesterday.

Representative REUSS. What you have said about social security taxes, which are, of course, a relatively regressive tax, brings up another question which is very much in the area of public discussion today, the question of income shares, in which taxation is partially but by no means wholly involved. Still I would like to ask you about it.

I am disturbed by the comparison of the figures from the Federal Reserve—they are the best figures we have—of the shares in the national income in 1968 and 1970—that is the most recent comparison we have. Whereas for a generation before 1968, the income shares of the five-fifths of the American people were getting more egalitarian, the discrepancy between rich and poor was decreasing, something happened in 1968 and thereafter, so that in 1970, the last year for which we have figures, according to the Federal Reserve, the percentage shares for the top one-fifth of American families went up a whole percentage point, from 40.6 percent to 41.6 percent.

The next to the top went down from 23.7 to 23.5 percent. The middle one-fifth went down from 17.7 percent to 17.4 percent.

The next to the bottom one-fifth went down from 12.4 percent to 12 percent. And the bottom one-fifth went down from 5.7 to 5.5 percent.

In other words, what happened was, the top fifth, the wealthiest families, went up a whole percentage point in their shares, and the other four-fifths of the American families went down in their shares, with the man in the middle hurt the worst.

Until somebody demonstrates to the contrary, I think what has been happening in this country—and I suspect it has gotten worse since 1970—is that between 1968 and 1970, unemployment almost doubled, inflation greatly increased in its rate, and the share of total taxes paid by the progressive Federal income tax was going down, while regressive local property and State sales and social security payroll taxes were increasing.

You put all of those together, and you have what to me is something very alarming; namely, a reversal of the beneficent trend that we had for a generation. If we keep on this way long enough, not only are there going to be some of the taxpayers' revolts that we are talking about, but it could just be that we are going to run out of purchasing power in the economy to take the product off the market in a given period.

And that is no way to run a free enterprise economy.

Now, this goes much beyond taxation, but fortunately, you and your concerns do, too. So, I would like your response to those Federal Reserve revelations.

Mr. COHEN. I am not familiar with the precise data, Mr. Chairman, I don't know exactly how that data is calculated. And I would like to examine it.

I can say with respect to the tax side that this is one of the matters that I have been very anxious to proceed to examine. From our computer models of the 1970 tax returns in relation to 1969 and 1968, the preliminary indications are that the 1969 act did significantly increase the effective tax rate in the upper brackets in relation to that in the middle and lower income brackets. However, we will not know that in detail for some weeks as yet.

But I agree with you that this is a matter that should be considered. I don't believe that the effects that you indicate are the effect of any changes in the tax law, because we gave a great reduction in taxes, as I pointed out, in the low-income brackets, and it looks as though we substantially increased the effective tax rate in the upper income brackets. The extent to which any change may be due to inflation and unemployment I do not know. I know that there were released this

morning figures with respect to the GNP for the second quarter showing a growth of some $30 million. And it is my understanding that—though I don't have the figures immediately before me—that they showed a substantial increase in real growth; I think, of 8 percent. Also the deflator was down significantly, and the Consumer Price Index for the month was up only one-tenth of 1 percent.

So, I think we have reason for encouragement, as you will see from the release of the figures today. I don't want you to feel that any 1 month figures represent a solution to the problem.

I now have before me the figures just released. The GNP results in the second quarter in constant dollars were up 8.9, and the deflator was 2.1 in the second quarter. And the Consumer Price Index was up 0.1 percent.

So, I think that we are making progress in that area, and in the employment area. I am not that familiar with the Federal Reserve figures to be able to comment beyond this. But I don't believe that the tax law changes in 1969, contributed to the changes reflected in the Federal Reserve figures you cited. Indeed, if it took place, it took place in the face of the changes in the tax law in 1969.

Representative REUSS. I would have just one more question, Mr. Under Secretary.

Congressman Vanik in his testimony before this committee earlier this week told us that a number of very large corporations, among them Continental Oil, McDonnell Douglas, Gulf and Western Industry, Aluminum Company of America, Signal Co., had large amounts of income in 1971, yet paid no Federal income taxes.

Is that true?

Mr. COHEN. Congressman, as I am sure you will recall, I am forbidden by law to state what any individual taxpayer or any corporate taxpayer has paid. I may not do that. I have some information on that, but I am not in a position to discuss the tax liabilities of particular companies. I have looked at Congressman Vanik's statement. In general he has taken the tax paid to the United States and compared it with the worldwide income. In general, he has used the forms 10K and the annual reports of corporations filed with the SEC, and taken the amount of the U.S. income tax paid, and related it to the worldwide income of those companies.

Now, he has used in this analysis taxable income for 1971. I don't see how he could possibly have known the taxable income for 1971, because most large corporations don't file their tax returns until September 15. If they are on a calendar year basis, they generally file brief estimated returns in March and get a 6-month extension of time to file their final returns. So, we wouldn't know their taxable income, and I don't understand how Congressman Vanik could know it. He may have guessed at it from trying to use financial accounting statements. But financial accounting and tax accounting are widely different concepts, for a variety of reasons which I will not trouble you with.

But the biggest problem is that he is using the U.S. income tax in relation to worldwide income. I think if you make a comparison, you should either use total income taxes paid worldwide in relation to worldwide income, or you should use the U.S. tax paid in relation to the U.S. income.

I don't think it is fair to the companies to present figures taking the U.S. tax in relation to the worldwide income.

I am told that Chairman Proxmire pointed that out to Congressman Vanik when he testified here, though I was not present.

So, I cannot speak with respect to the individual companies. At least one company I know has announced that it did pay tax. And others have announced that the figures are inaccurate. Indeed, it seems to me that the figures must be inaccurate, at least to some extent, because we just couldn't know what the tax figures are for 1971, before the returns are filed.

Representative REUSS. Mr. Brown.

Representative BROWN. Mr. Secretary, can you give me figures on the effect of the tax law changes in 1969 and 1971, at various income levels? In other words, what was the impact in terms of tax paid on the average citizen making $5,000, $10,000, $15,000, and so forth?

Mr. COHEN. If you have a copy of my prepared statement I have tried to set forth in table 2 of my prepared statement, breaking it down by income levels. And I show the income classes at the left. And this is calculated in relation to 1971 levels of income. We can do this at the moment only with respect to 1971 levels of income.

Representative BROWN. So this is not related to inflationary factors or anything else. This is taking one income level and not saying that it would be more by the time 1972 rolls around than it was in 1968?

Mr. COHEN. We could give that to you in the aggregate. As I understand it, for the year 1972 or even the year 1973 we can estimate what aggregate GNP and personal income would be, but when we try to break it down by income classes and do it in a fairly accurate way, we can do that only for the year 1971 at the present. And that is why we used 1971 levels of income. But using those levels of income, the second column shows taxes that would have existed under the law prior to 1969, and the next column shows tax under 1972 law. So, the difference is the effect of the 1969 reform act, the regulations under the asset depreciation range system, and the Revenue Act of 1971. And you will see that the individual tax liability has been reduced by $11 billion, from $94 billion to $83 billion. And in the last column it shows the percentage reductions, in the lowest level an 82 percent reduction, and at the next level, 43 percent. You see the percentage reductions decrease as the income levels rise, until you get to the level of adjusted gross income of $100,000 or more, where there is an increase of 7.4 percent.

Representative BROWN. These are individual income taxes and not corporate income taxes?

Mr. COHEN. That is correct.

Representative BROWN. Let me ask one other question about these statistics.

Do they include the reduction in the excise tax or the removal of the excise tax on automobiles?

Mr. COHEN. No.

Representative BROWN. The average citizen, I suppose, buys an automobile once every—how many years, 5 years, 4 years?

Mr. COHEN. I don't know.

Representative BROWN. When you figure out how many automobiles there are on the road and how many automobiles were sold last year, I would judge it must come out to once about every 4 years.

Mr. COHEN. I was going to say that it might be affected by whether they join the Government or not, because they buy them less frequently after they join the Government.

Representative BROWN. I will make that plea, but not comment on it.

At any event, that it is not reflected in this, which would mean a further reduction in the individual Federal taxes, I assume, is that correct?

Mr. COHEN. If you will turn to that section of my prepared statement, it there deals with the complete categories of corporate income taxes, individual income taxes, and excise taxes. You will see that for the 4 calendar quarters of 1972, there will be a reduction in the excise tax on automobiles and telephones, mostly affecting individuals, of about three and a half billion dollars. Some of that affects corporations, but most of it is with respect to individuals.

For the current calendar year 1972 we estimate that excise tax reduction, largely due to the elimination of the excise tax on automobiles and small trucks, was about $2.6 billion.

Representative BROWN. So, when we are talking about tax reform in effect from these statistics, we are talking about tax reductions for darn near everybody, with the exception of the $100,000 income and over?

Mr. COHEN. Yes.

Representative BROWN. And some corporations. And that depends on whether the corporations make substantial investment in new plant equipment and all that sort of thing?

Mr. COHEN. Yes; that is correct.

Representative BROWN. What I am trying to figure out is where the crunch on the middleman then comes, because I think we have to figure out the things that are being done for people and corporations by Government when we consider not only who pays but who benefits. And I would like to relate to you a conversation that I had the other day with a constituent of mine. I spent my 10 days while the Democrats were basking in the sun of Miami out in my constitutency visiting 20 different communities on the two-a-day basis, listening to people's problems. And if I heard this complaint once, I heard it probably 10 or 12 times a day from different people. And it ran like this. I will give you the most eloquent presentation that I had from a man who works in a factory on the assembly line. He said, You know, Congressman, I have worked on the line all my life, and I dreamed of the day when I would be making $10,000 a year—and then I learned that it is now the national average, a little over $10,000—I dreamed of the day that I would be making $10,000 a year, so that when I was making $10,000 a year I could afford anything I really wanted. And what I wanted most was to be able to send my youngsters to college, something that my parents could not afford when I was young." He said, "I have been making $10,000 a year now for almost 2 years, and I suddenly discovered that I cannot afford to send my youngsters to college because so much of my money is being taken to assist in the college education of the youngsters of people who have not worked as long as I have, or who are not doing as well as I am now."

And he resented that very much, because he said, "Maybe I ought to throw in with them, and then my kids would be able to go to school, in other words, maybe I could just go on welfare and be in some low-

income arrangement by not working so I could get more assistance from the Federal Government."

So this is a double-edged sword, I guess, not only what we are doing for people, but what we are doing to them in the way of the tax structure.

The argument that he presents is that it is the guy in the middle who is paying, and that that is destroying incentive, and the result of that will either be that a lot more guys in the middle will have to fall into the supported class rather than the class which shows incentive to try to support others.

Now, I find that a pretty distressing situation, and a pretty distressing commentary, and a very distressing attitude, because we go by the Judaic-Christian ethic where we are supposed to help people, and yet there are a lot of people who feel like they were being made for a sap in this situation by those who maybe don't care to make the effort, and that you have now got it down to a pretty low level, where you are making life difficult for people by taking from them.

Now, related to these figures about the tax reduction, which show that we are reducing it for everybody, and yet we are providing more and more services—I guess I can only suggest the deficit as an example of that—and things like the recently passed education bill, which increased the budget by $2 billion in the House and considerably more, I guess, in the Senate—what comment do you have to make? Are we going to have to confiscate income above a certain level, or are we going to have to reneg on all these tax reductions that we have made with the administration recommendation and congressional approval, or where are we headed on this problem?

Mr. COHEN. Let me point out at least one matter that we have to consider in relation with the individual income tax.

We reduced income taxes, as you see from that schedule before, by some $11 billion for 1972 as compared to 1968, based upon the same levels of income.

Now, one of the reasons for that is that we have a highly progressive income tax structure, and as we have a better earning capacity arising from rising standards of living and education, and as you have inflation, incomes go up into higher brackets, and they are subject to higher taxes because of the progressive rate structure.

Now, if you go back 10 years roughly and eliminate the 1964 act which reduced tax rates, and the 1969 act, and 1971 act, you would find that the individual income tax, the effective income tax, would have risen to 14.7 percent of total personal income. It has never been that high. It has fluctuated from a low of 10 percent in 1965 to a high of 11.6 percent in 1969, averaging just below 10.9.

And we now have it at about 10.6 percent. So, one of the difficulties that we have when you project ahead is that if you don't project ahead a reduction in tax rates or some change in the law, the individual income tax eats up a higher and higher percentage of personal income.

Representative BROWN. Let me try to point up my question just a little more precisely.

My friend here that I was talking about was at the $10,000 level, the average U.S. income level. And according to this his taxes have either been reduced by—well, somewhere between 13 and 17.5 percent. But he is feeling that though his taxes have been reduced, he is substantially

less able to do the things that he would like to do with that money, but that somebody whose taxes may have been reduced 27 percent, or 42 percent, who is in a lower income level, is relatively better off than he, because of what our society will do for that kind of a person.

Now, what I am getting at, I guess, is that as we increase the level at which we will do for, we seem to be hearing the level at which we do things to incomers, and thereby we force higher and higher this nonincentive level where people just say, well, let's chuck it and let Uncle Sam take care of us. That is what I am trying to get at. Isn't it necessary to relate in terms of tax reductions, and so forth, the benefits that come from those taxes that accrue to people at this level, and doesn't that give us some figure at which somebody is either a taxpayer or a tax user?

We face in our society this year the issue of the $6,500 guaranteed annual income. If that guaranteed annual income was $10,000, the statistics would be fairly simple. Leaving out the corporation, you would just take everything that anybody makes over $10,000 and give it to anybody that makes under $10,000 and you could assure everybody an average $10,000 income. And then you finance the rest of the Government operations from corporations. But what does a $6,500 annual income do to us?

Mr. Cohen. You point out a very important factor, Mr. Congressman, that when you increase Government expenditures and you have to finance them, you have got roughly three groups, a lower income group, a middle-income group, and an upper income group. And no matter how heavily you tax the upper income group you can only get so much out of them, because it is just not that large a group. And you can't tax heavily the low-income group. So as you increase expenditures, and you have to develop the revenue, you develop it necessarily from the large body of middle-income persons, because they are the ones that are the backbone of the Nation.

I might say that there are other factors that affect your constituent's problem. The obvious one is that the cost of college education is rising. I might say that when my oldest boy was in college, I complained, as a father does, about the level of his expenditures, and how hard one had to work in order that after tax one could afford this for him. He pointed out, "Dad, don't work that hard on my account, because if you had nothing I could get a scholarship."

Representative Brown. That was precisely my point.

Of course, if he went to your school where you taught he would probably get a break on his tuition, most colleges do it that way.

My time is up. I am going to ask you to supply some information. I would like to know if you could break down these same figures based on incomes so that we could have some idea at what level we would have—if we decided we were going to confiscate high incomes above a certain figure, how much we would take in in the Federal Government?

In other words, if you wanted to confiscate all over $100,000 income, and all over $50,000, and maybe over $10,000, I would like to know what you can take in, because we are faced with a couple of propositions, or maybe faced with a couple of propositions, whereby we had to come up with $210 billion, or a thousand dollars for everybody a year, or the $6,500 guaranteed income.

I don't know what we can get out of the people who are earning income to pay for those proposals. And I don't have the statistics. I assume you do.

Mr. COHEN. These are readily available for 1970. According to the preliminary statistics, the taxable income of the group with adjusted gross incomes above a hundred thousand dollars would be $11 billion. And they paid in taxes $5.7 billion. So, you could get about another $5 billion out of them based upon their present taxable income if you had 100-percent tax, and you assumed that they were all still going to work and invest.

But this calculation is open to the question as to whether you want to change the base of taxable income. This is a point that the chairman and I were discussing. For example, this will not include State and local bond interest, and matters of that kind.

If you assume the existing income tax structure, at least the one applicable in 1970, you could by a 100-percent tax on the adjusted gross income class above $100,000, raise about $5 billion.

Representative BROWN. What about above $50,000, above $20,000, and above $10,000, the figures that you have here?

Mr. COHEN. If you take it above $50,000, even 100-percent tax on adjusted gross income above $50,000.

Representative BROWN. That is above $50,000 or $50,000 to $100,000?

Mr. COHEN. No; I am talking about all above $50,000. I could do it the other way, but this is easier.

Representative BROWN. That is all right, whatever you have there.

Mr. COHEN. They had a taxable income of about $29 billion, and they paid an income tax of $12.4 billion. That is an effective rate of income tax based upon taxable income of 42 percent. If you raise that to 100 percent, and take all of their income, I think we will get $17 billion. But obviously if you took 100 percent of their income a lot of people would not work.

And of this income—I can't say in that category how much of the income is salaries and wages and how much is dividends—some of it will continue to flow in as investment income, but a good part of it is also salaries and wages and business and professional income.

But obviously you can't consider a 100-percent tax.

Representative BROWN. We are not into my category yet. Can you get the $20,000 and $15,000, and then I will leave you alone?

Representative REUSS. Your request is that the Under Secretary provide those for the record?

Representative BROWN. Unless he has them available here.

Mr. COHEN. Do you want to assume a 100-percent tax on everyone above $20,000?

Representative BROWN. Or $15,000, either one.

Mr. COHEN. I get more and more nervous as we go down. You have already gone below my published salary level, you realize, and below yours.

But at $20,000 or more the taxable income is $102 billion. And the tax paid is $30 billion. So, you could pick up, if you make the assumptions that all this would flow in the same way, about $72 billion by a 100-percent tax on everybody with an adjusted gross income of $20,000 or more. But I can't conceive of attempting to do that.

Representative BROWN. That would just about cover the health insurance proposal for next year.

Thank you very much.

Representative REUSS. Of course your answer to Mr. Brown's question was based again on this adjusted gross income figure, which, as we have said, excludes capital gain, oil depletion, tax exempt bonds, and life insurance savings, and so forth.

Representative BROWN. I just want to point out that the predicate for my questions are that I figure that the tax exclusions that we currently have amount to about $49 billion, and that I ask the Senator—from a list of those I picked out the largest sources of money that are presently tax exclusions, the home mortgage, the charitable contributions, the municipal bond interest, and so forth, and found, after our conversation, that there were $21 billion of those he would not consider removing as tax exclusions, of the three that I mentioned, plus several others.

So, we are left with $28 billion in that amount. I assume that most of those exclusions would fall in this over $20,000 category?

Mr. COHEN. I provided as an appendix to my prepared statement a breakdown of the various preferences on that list by income categories. And many of them fall in the middle-income categories. The biggest ones in the $100,000 and over category, are capital gains, the deductability of State and local taxes, the exemption of interest on State and local bonds, and the deductability of charitable contributions. I don't know what can be said with respect to those. They are the major categories. And the problem of capital gains taxation, which is the biggest item affecting the upper income group by far, is the one that we have been debating for 30 or 40 years.

And I point out in my prepared statement that when you consider that, and you consider the fact that most capital gains, at least half of capital agins in round terms, are derived from stocks of corporations, you also have to consider the effect of the corporation tax burden, as to whether that is borne by consumers or borne by shareholders.

If you assume that that is borne by shareholders, then you have a half or three-quarters or whatever assumption you want, as shown in appendix F attached to my prepared statement. And that is a heavy burden in the upper income levels, too. So, as you would consider capital gains taxation, you would have to consider also the burden of the corporation tax, and where that falls.

Representative BROWN. Thank you. My time is up.

Representative REUSS. Thank you very much, Mr. Under Secretary, for your patience and helpfulness.

Chairman Proxmire has a number of questions, I think largely of a statistical nature, that I will give to you shortly for inclusion in the record as you are able to prepare them.[1]

And I would have just one additional question, not for an answer now, because I am sure you can't, but again for inclusion in the record when you are able to do it.

Would you give us the Treasury revenue estimates for closing each of the preferences in the Mills-Mansfield bill? That is the one that the Treasury said was an interesting approach. Could you give us the estimate, both on total and partial closing, whatever seems to you the sensible way of getting at it.

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[1] The response of Mr. Cohen to a number of written questions posed by Chairman Proxmire was not received at the time of printing the hearings.

Mr. COHEN. Mr. Chairman, we have such estimates, but I would not attempt at this stage to say which of those changes would be sensible and which would not be. And neither has Mr. Mills, as you recognize.

Representative REUSS. I didn't mean you should make a value judgment, just base your answer on the revenue yield involved in closing them. And if on a particular loophole you want to break that down into a number of alternative assumptions, you are welcome to do it, that is all I was saying.

Mr. COHEN. I can answer this in broad terms.

Representative REUSS. I think that it perhaps would be more useful for us, and maybe a little easier for you, if you are able to provide us with whatever you can on that for the record.

Mr. COHEN. Yes; I will be happy to.[1]

Representative BROWN. I don't understand that. This appendix E of your prepared statement is all tax exclusions, not those in the Mills bill; is that right?

Mr. COHEN. There is a considerable difference between the list of tax preferences in the study which the Joint Economic Committee staff selected, and the list of 54 items in Mr. Mills' bill. The information that we provided in the appendix to my prepared statement dealt with a list selected by the Joint Economic Committee staff. Now, Mr. Mills' list of 54 preferences is compiled in a different way. There are some 16 or 18 items that are on the committee staff list that are not on Mr. Mills' list, and a comparable number that are on Mr. Mills' list and not on this list.

One of the things that has to be borne in mind is that Mr. Mills picked only those provisions or those preferences that are dependent upon existing provisions in the Internal Revenue Code itself, for which you could provide a termination date. But some other items, which don't depend upon the code itself but have grown up just out of rulings or case law, can't be terminated in that way and are not on Mr. Mills' list.

Representative BROWN. What do appendixes D and E of your prepared statement refer to?

Mr. COHEN. Appendix D refers to every item that the Joint Economic Committee staff asked us for or included in the tax subsidy study. There are other items on Mr. Mills' list that I have not provided for, but the chairman has asked me if I would provide those for the record. And I will do so.[1] We have them available. I do not prefer, since I have given that list to Mr. Laurence Woodworth, the chief of staff of the Joint Committee on Internal Revenue Taxation, to have him check it to make sure that he agrees with it.

Representative REUSS. That is why I think it is more useful for you to do that at your convenience.

Mr. Conable.

Representative CONABLE. Mr. Cohen, I got stuck in another meeting, and I am sorry to have missed your testimony, because I know what contribution you made to the Tax Reform Act of 1969, and I know you are the leading expert in the field of tax reform in the administration, and probably elsewhere. I would like to ask you, we

[1] The information to be supplied for the record by Mr. Cohen was not received at the time of printing the hearings.

have heard some allegations that we have not brought up estate and gift tax reform during the past 3 years, as a result of Treasury opposition. This is not so, is it? You are willing to make your recommendations available any time the Ways and Means Committee is ready to hear them; isn't that correct?

Mr. COHEN. Yes, sir. The Ways and Means Committee report on the 1969 act said, as you will recall as a member of the committee, that time did not permit consideration of estate and gift tax reform at that time, but that the Congress would take it up in the following session. It has not done so. We have conducted a good many Treasury studies, and I have said repeatedly that we would be ready when the committee is ready to take it up. I understand that that will be a part of the legislation considered next year.

Representative CONABLE. Is it your understanding now that there has been a commitment on the part of the Ways and Means Committee to take up tax reform as the first order of business in 1973?

Mr. COHEN. You would know better than I but that was the tenor of the discussion at the executive session at which I was present, and I understand that to be so. I said in my prepared statement that the President has stated that he will be prepared to make recommendations for legislation by the end of this year, which I take to mean the beginning of the next session, and both Chairman Mills and Senator Long, as I understand it, have pledged that this will be taken up as the first order of business next year.

Representative CONABLE. Is it your feeling that something should be done in the area of estate and gift tax reform? Nothing has been done in that for a long time. Do you have any general feeling about whether or not that should be considered, regardless of what kind of proposals that are presented? How do you feel about it?

Mr. COHEN. I think it should be considered and reviewed. We have had very little review of the estate and gift taxes, except on an administrative matter a year or two ago, since the early 1950's. The rate structure that is in effect today, as I recall it, is the rate structure that was put in in the Revenue Act of 1942, and it needs a thorough review. The answers are not easy, and a great many lawyers and economists and others are quite divided over what the type of changes should be, but I think it is clear that it should be reviewed.

Representative CONABLE. Is there any other area of the code besides the income tax in addition to estate and gift taxes that you feel should have the attention of the appropriate congressional committees who are charged with the responsibility for legislation in this area?

Mr. COHEN. The bulk of our revenues come from the income tax. I think at the present time we estimate on the order of $93 billion from individual income tax, and about $36 billion from the corporate income tax. And, of course, the social security taxes, as you well know, are very large proportion of the total.

Representative CONABLE. That is increasingly a dominant part of the issue, too, progressivity?

Mr. COHEN. I sat in the gallery while you so remarked on the floor of the House on the evening of June 30. And so I well know your position on that. This is not generally in my area of responsibility, but more in the area of HEW's.

But beyond that, I guess the principal source of revenue is from the alcohol and tobacco taxes. There are some changes that are constantly in order in those taxes, so they might well be reviewed also.

Representative CONABLE. May I ask you also, Mr. Cohen—you have recently been promoted to the position of Under Secretary, for which we congratulate you. But is that going to change your duties with respect to tax policy, or is that settled yet? I hope you will continue to work in this field, frankly.

Mr. COHEN. I understand Secretary Shultz says that I am supposed to continue to work in this field. My former deputy, Frederick W. Hickman, has been nominated to be Assistant Secretary for Tax Policy. And I understand that while my duties are to be of a more general nature, I am also to continue to work in the tax field with the Secretary and the Deputy Secretary and the Assistant Secretary.

Representative CONABLE. That is fine. I am glad to hear that.

Again, my apologies for being late.

Representative REUSS. Thank you very much, Mr. Cohen. We appreciate your help as always.

Mr. COHEN. Thank you, Mr. Chairman.

Representative REUSS. We will now ask the patient Professor Erickson, Professor Leontief, and Professor Musgrave to step up.

We appreciate very much your patience, and we would like to have you now proceed.

We will start with Mr. Erickson, if he is ready to give the substance of his testimony.

I might say that we have prepared statements from all three panelists which under the rule and without objection will be admitted in full to the record, if you should abbreviate them.

STATEMENT OF EDWARD W. ERICKSON, ASSOCIATE PROFESSOR OF ECONOMICS, NORTH CAROLINA STATE UNIVERSITY

Mr. ERICKSON. Thank you. Mr. Chairman.

I have a very brief and I think very general statement that I would like to make.

In "Taxes, Goals and Efficiency: Petroleum and Defense," Professor Millsaps and I argued that there were four possible reasons through which percentage depletion for the oil industry might be justified. These reasons are:

National Security; adjustment for risk; a preference for a strong mineral industries; and tax neutrality.

We argued, I hope convincingly, that the only really substantively valid reason for considering special tax provisions for oil and gas was national security.

The market can adequately adjust for differential risk. I do not believe that anyone can, in good conscience, argue that the special tax provisions enjoyed by the petroleum industry originated or were perpetuated as a risk offset.

The strong mineral industry argument is a blind alley. We desire all our industries to be strong, but do not have sufficient resources to maximize "strength" across the board. No useful policy prescriptions can be derived from an unalloyed strong mineral industries argument. We need a definition of what strength is and how much strength costs.

The tax neutrality argument, while interesting from professional point of view to economists is, I think, from a public point of view absurd. This statement is not an attack on the work of my professional colleague, Professor Stephen McDonald. I greatly respect Professor McDonald and his work. But Professor McDonald originally constructed an ex post facto rationalization of the depletion allowance. If tax neutrality had been an overriding concern of Congress, I would not be testifying today and there would be no need for the studies which have been developed for these hearings.

That brings us to national defense. In my opinion, there is an arguable position that percentage depletion and the other special tax provisions enjoyed by the petroleum industry make a positive contribution to national defense. This contribution is a result of the effect of special tax provisions to induce a larger quantity of domestic oil discoveries and a higher domestic production/demand ratio than would otherwise be the case. The problems involved in evaluating such a contribution are fourfold:

1. What contribution is necessary,
2. How large is the contribution made by current tax subsidies,
3. How much does it cost, and
4. Are tax subsidies the least cost way of achieving the desired effect?

And at this point I suppose I ought to apologize, because one of the areas of my professional work is to develop empirical estimates of the various relevant responsivenesses of the oil industry. And the statement I am about to make is a reflection on my own efforts to date.

The state of our empirical knowledge with regard to these important questions is shocking. We simply do not know the answers. Assume for the moment that there is some well defined relationship between domestic oil reserves and national defense. If we abolish the special tax provisions enjoyed by the petroleum industry, domestic discoveries, reserves and production will decrease. Such a decrease may have an injurious effect upon the national defense. Such an injurious effect may be directly offset by higher domestic prices which counteract the elimination of depletion and other special tax provisions, or it may be indirectly offset by other policy actions such as storage and defense reserves. There is a price-cost-tax tradeoff which must be defined, and against which desired policy outcomes must be evaluated. Such a tradeoff is not now well-defined. The mode of analysis which defines these tradeoffs must be block-recursive—and I apologize for this jargon—and the justification of means and results must be separated. This has not been the case to date. The tradeoffs can and will be defined. In the process, the special tax provisions enjoyed by the petroleum industry will be substantially altered, but I urge that public policy be made in the context of a national energy framework.

Thank you.

Representative Reuss. Thank you, Mr. Erickson.

We will hear from the entire panel before we start our questioning. Mr. Leontief, please proceed.

STATEMENT OF WASSILY W. LEONTIEF, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. Leontief. Mr. Chairman, I think I can read my statement in 10 minutes. It is brief.

Having been asked to offer general comments on the economy of Federal subsidy programs I studied with much interest the record of the hearings held last January 13, 14, and 17 and the reports prepared by your staff and special studies submitted by outside experts.

I wish you had declared the figures presented on the pages of these most interesting documents to be "classified information." Jack Anderson would have leaked them in his column and the New York Times would have reprinted a large part of the text on its pages. The average citizen would learn that while the Federal Government spends some $4 billion on Medicaid and Medicare and about the same amount in support of education, its subsidies to upper income groups—that take the form of income tax reduction on capital gains and special depletion and depreciation allowances to corporations—add up to some $11 billion. His incredulous reaction to this and other figures showing who subsidizes whom and in what amounts, I am sure, would be similar to that of the pajamaed fellow in the recent TV ad: "How could so much dough have been passed around without me being aware of it?"

But levity aside, the ignorance of the great majority of voters of the remarkable fact that some $12,300 of spendable income per every family is being redistributed, most of it through massive subsidies not shown in the Federal budget, should not be tolerated any longer.

To assess the effects of a specific Government action—or as the case may be inaction—on the material well-being of various groups of citizens is certainly a highly technical task. So is the task of developing proposals for legislative and administrative measures that would redirect the use of primary resources and the flow of final goods and services produced by our economy so as to bring about this or that change in the conditions of various groups of the population.

Your staff and the invited experts have shown how much can be accomplished in a few months on a modest budget. These hearings have also amply demonstrated that no satisfactory progress along the lines of such technical analysis can be achieved without substantial—and I mean substantial, not marginal—strengthening of the statistical data base. Without such strengthening even the most sophisticated arguments amount to no more than theoretical speculation. Moreover, by now it should be clear that to find out where we actually stand and where we could go from here each individual situation must be assessed in full detail; but this is not enough; we have to keep in full view the entire picture.

And I would like to add this. To discuss each tax separately really is not a sufficiently broad approach. What really counts to an individual is how the whole picture as a whole affects him. I think in the questioning Congressman Vanik was undertaking to ask, how about a reduction in the automobile excise tax? It is not an income tax, but it obviously affects everybody's situation. It is a very interesting question. I don't know whether it was General Motors or the consumer or how it was divided. But it was a very difficult question, and it involved a lot of factfinding on the subject, as the last testimony showed, on the oil depletion problem. One can argue, but you have to really form an informed judgment, and a very systematic view of the entire situation was impossible.

As in human organism all parts, all functions, of our national economy are interdependent. A measure, a transfer that favors one

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group of people may also benefit another but impose a sacrifice on a third. Modern techniques of economic analysis, supported—I emphasize again—by requisite sets of factual data, permit us to assess not only the direct but also the more remote indirect effects of taxes, subsides, and other economic measures.

If we want to see the picture as a whole, at some stage of the discussion analysis we should be—and I mean we not as specialists but as citizens representatives—presenting that picture.

In this connection it is somewhat surprising that most of the theoretical arguments presented in the special reports prepared for these hearings are developed in terms of the supply-demand approach which is incapable of tracing the effect of any tax or subsidy beyond the group directly benefiting from it or penalized by it. In most instances, this is not good enough even—we have to use the techniques which enable us to trace the things now a little further. In most instances, this is not good enough even if the argument is illustrated by a graph or described by a set of mathematical equations.

The transactions that you are examining involve not millions but hundreds of millions, and billions of dollars. Nevertheless, the amount of money appropriated by the Congress for finding out how these transfers affect our economy in general, and the welfare of different groups of producers and consumers in particular, is smaller than that spent by, say, Lever Bros., for development of a new detergent. What is even more distressing is that the efforts devoted to and the funds available for helping each voter to find out how these billions of dollars of taxes and of subsidies affect his own and others' incomes is much smaller than that—I come to the same comparison—appropriated year in and year out by a middle-sized corporation for promoting its products.

Taxation is too serious a matter to be left entirely in the hands of experts. An expert should be better able than an ordinary citizen, or even, with all deference, I will say an average legislator, to figure out whom a particular tax exemption or subsidy benefits or hurts directly or indirectly and by how much. But who is he to decide why a particular distribution of benefits and sacrifices should be preferred to another? This is a political question. There is no reason why, in arriving at an answer, the Congress should give greater weight to the personal opinion of a tax expert, or of any expert, than it gives to that of any other voter. Having ascertained and presented the relevant facts and figures the experts should get into line and cast their ballots with everyone else.

This is how it should be in principle. In real life it is not quite so. In real life the battle of opposing economic interests—it is not a world of harmony, but a world of hard times—spills over into what, ideally, should be the preliminary stage of factfinding by impartial experts. The contest of economic interests takes on the guise of a battle of experts.

In a criminal inquiry—its subject matter being understandable to all ordinary people who make up the jury—the adversary procedure may be conducive to bringing out the facts. In the case of the technical analysis of complex economic phenomena, more often than not, the adversary procedure tends to obfuscate rather than clarify the understanding of a given or even hypothetical situation. Confronted

with several contradictory and highly technical presentations which he can't really follow, the individual citizen—and I add with all deference, sometimes even a legislator—naturally tends to accept the argument whose practical conclusions serve his own or his constituents' special interests. The less known about a given situation, the greater the number of perfectly respectable interpretations from which to choose—these documents show it very clearly—and, if the stakes are high and one's financial resources large, one can always generate still one more interpretation. This, Mr. Chairman, is why the present inquiry is so very important, because you have really already assembled very important facts. It is only a beginning.

The interests of differently situated groups in our, as in any other, society will seldom coincide, but the political contest between them should be fought on a firm, clearly staked out ground of solid knowledge. It may well be time to add a fourth branch to the three great independent branches of our Government. Its sole—equally independent—function should be to level and maintain the ground of knowledge on which these battles are being fought.

The support of this research should be at least as ample as that provided now, let's say for the development of new weapons. The more of the factfinding work that is conducted in the form, not of special assignments, but of a detailed, systematic description of the structure and the functioning of our economy, the less the danger that it will be slapped by the Congress.

Whenever you begin to study and the controversy is already there hot, you have got simply a conflict testimony, not necessarily the fact.

In some of the prepared statements, and even more in the course of verbal hearings—I mean the January hearings—the question of governmental interference with the operation of free private enterprise comes up again and again, and I would like to say something for you on that subject, because this is a subject that will be coming up again and again.

The pursuit of private economic gains is certainly the mighty power source that propels the American economy forward. This is our great source of power. Under our system of free enterprise the profit motive in particular promotes and safeguards our unequaled technical and managerial efficiency—I mean the managerial efficiency of our economy, particularly the private economy. This is the wind that keeps the vessel moving. This is the profit motive.

But to keep it on a chosen course we have to use a rudder. The steering gear consist of taxes, subsidies, and other measures of governmental economic policies. There are, of course, those who say that we should simply hoist the sails and let the vessel go before the wind in whatever direction—in this case it is the profit motive—it happens to be blowing. The great majority clearly does not trust this type of navigation, it is a special type of navigation. It understands that instead of carrying the passengers where they want to go it will land the ship on the rocks: the stronger the wind, the faster it will do so.

In some socialist countries, on the other hand, they have taken down the sails, and thus lost the driving power of the profit motive. No wonder the rudder has lost its steering power, too. If you don't have a movement forward, your rudder just doesn't operate. Some of these economies are cautiously returning to sail power; others still try to

propel themselves by planned paddling in the hope that soon a new kind of engine will be invented one that can drive an economy without reliance on the tradewinds of the profit motive.

I think you will have to wait for a very long time.

Private enterprise made this country the most prosperous in the world, and our economy will, of course, rely on it as its main driving force for a long time to come. But to keep on the right course, we certainly have to use the rudder and, by all indications, we will have to lean on it more heavily in the future than up to now.

And here I am coming to the really crucial operations. The use of a rudder is bound to cut the speed in the economy as it does on water, but this does not mean, of course, that it should be abandoned, but it is a very crucial operation. The rudder is like a little brake, which works in one particular direction. The art, or the science if you want, of using the power of the wind while steering the vessel on a chosen course different from the direction in which the wind is blowing is known as tacking. All administrations tack. And the last one—I think our sails are still flapping.

I personally feel, as a citizen not as an expert, that our society has been moving for too long in the direction in which the forces of unguided private profit motive are driving it. If this is true, the time has come to correct the course by tacking.

A significant transfer of tax burdens from lower to the upper income groups and of benefits from various Government subsidies in the opposite direction might indeed reduce private savings; though I'd still like to see a solid realistic estimate of how much. I want to be very frank about this thing. I don't want to argue that everybody will benefit from whatever you do. It is a sacrifice. But I would still like to see a solid realistic estimate about how much would the saving be reduced.

As Mrs. Musgrave's most interesting study—which is already printed, and I suppose she will present it in testimony—shows the rescinding the preferential tax treatment that encourages the massive overflow of U.S. capital abroad could more than compensate—so far as private domestic investment is concerned—for that loss, even if domestic investment is, let us admit, possibly slightly reduced, if we reduce or eliminate the preferential treatment of capital gains, by just lightly closing the door through which billions of capital flow—how much is it, $40 billion by now in Europe?—it would force it back in the domestic economy.

Moreover, with the pressing needs for all kinds of additional public investment, employment in any case could certainly be kept up.

Government action designed to increase the shares of the lower and, in particular, the lowest income groups in the fruits of economic progress may reduce its pace. But we should be prepared to pay the price of social progress. Countries with low or even average levels of productivity must struggle to maintain efficiency, but the United States is fortunate to have created the most efficient economic system in the world. Is it not simple commonsense to trade some of our abundant assets for others that we sorely lack?

That is my statement.

Representative Reuss. Thank you very much, Mr. Leontief.

Mrs. Musgrave, please proceed.

STATEMENT OF PEGGY B. MUSGRAVE, ASSOCIATE PROFESSOR OF ECONOMICS, NORTHEASTERN UNIVERSITY

Mrs. MUSGRAVE. Mr. Chairman, I should like to present a statement on tax preferences to foreign investment which summarizes my paper appearing in volume 2 of the committee's "Federal Subsidy Studies."

Given the size of U.S. investments abroad and the important role which they play, the tax treatment of foreign investment income must be a major concern for tax policy.

The book value of privately held U.S. investments abroad is currently in excess of $120 billion of which some $80 billion is direct investment in affiliates of U.S. corporations. These foreign affiliates produce an annual output of at least $150 billion and earn before-tax profits of $18 billion, or about 20 percent of total U.S. corporate profits. This direct investment abroad is very largely undertaken by the large corporations and is more concentrated than is domestic corporate investment. It is also centered in manufacturing industries in Canada, Western Europe, and other industrially advanced countries and in the petroleum industry in Canada and the Middle East. Additions to this investment in the form of capital outflow and reinvested foreign earnings continue at an annual rate of some $7 billion.

Major tax concessions are provided this investment in the form of the foreign tax credit, tax deferral, and tax preferences given to the Western Hemisphere trade corporations, the so-called less-developed country corporations and investment in the U.S. possessions. In consequence, the U.S. corporate income tax paid on $17.5 billion of before-tax foreign profits was only $900 million in 1970, after allowing for foreign taxes of about $6.5 billion.

Taxes paid abroad are credited against the U.S. corporation tax upon repatriation of profits. Such credits claimed in 1970 amounted to about $4 billion, including both foreign profits taxes and withholding taxes on dividends. The case for crediting is that, provided the foreign tax is not shifted, it secures tax neutrality with respect to the choice between domestic and foreign investment. Indeed, our crediting provision overshoots the mark because it applies to local as well as central taxes paid abroad, whereas for the domestic investor business income taxes paid to the States and localities may only be deducted from taxable income.

As a matter of tax equity, as distinct from that of tax neutrality, the credit may be defended by arguing that horizontal equity calls for equal total tax burden on the same income and that this includes both foreign and domestic taxes. But horizontal equity may also be interpreted to call for equal treatment in terms of U.S. taxes only with foreign taxes being treated as costs of doing business and therefore deducted as is the case with State and local income taxes in the United States.

Thus the choice of the credit method is not a compelling one on equity grounds.

However this may be, neutrality and equity are not the only considerations. Foreign investment performs a complex economic role and many aspects of international, national, and sectional interests must be weighed. From the point of view of national productivity, for instance, it could well be argued that foreign profits taxes should be

deducted rather than credited. By putting the foreign investment decision to this more demanding test, investments made abroad would be limited to those with returns (net of foreign tax) at least as high as gross—before taxes—returns to investment in the United States. It might be argued that from the point of view of U.S. self-interest this is the proper solution.

Turning now to tax deferral, this provision permits the profits of foreign incorporated subsidiaries of U.S. corporations to enjoy a deferment of U.S. tax until remitted as dividends. Since most earnings retained abroad are reinvested in fixed assets this virtually amounts to a permanent exemption from U.S. tax. It is estimated that the average effective rate of foreign taxes on profits of U.S. affiliates abroad is of the order of 36 percent and that foreign subsidiaries of U.S. corporations paid nearly $1 billion less in foreign profits taxes than they would have paid under the U.S. corporation income tax. Deferral clearly introduces a nonneutral incentive to invest abroad and is difficult to defend on both equity and efficiency grounds.

Furthermore, there seems to be some logical inconsistency between deferral, which arises from the rule under which the United States does not tax the foreign income of foreign corporations—even though under U.S. ownership and control—and the indirect tax credit which allows the taxes paid by these same foreign corporations to be credited against the U.S. tax when such profits are remitted as dividends. I would submit that the availability of the indirect tax credit should be made contingent upon the termination of deferral.

The effects on U.S. revenue of the deferral and credit provisions interact and are not easily summarized. If both provisions were to be eliminated, that is, foreign taxes were made deductible only and U.S. taxes were applied when foreign income was earned, the U.S. revenue gain is estimated at $3.3 billion. This figure may be on the high side if allowance is made for the effects of such changes in raising the payout rate, thereby increasing foreign withholding taxes. That is to say, if the payout rate should rise as a result of these new tax measures, there would be an increase in foreign withholding taxes to credit against the increase in U.S. taxes.

If deferral only was to be terminated, while the credit was continued, the revenue gains may be estimated anywhere between $160 and $900 million, the precise amount again depending on the payout response.

Western Hemisphere trade corporations are provided a 14 percentage point reduction in their U.S. tax liability, representing a tax preference worth some $115 million. Less developed country corporations were permitted to retain a variety of dubious tax preferences which were eliminated for other corporations in the 1962 Revenue Act, preferences which account for another $50 million or so of revenue.

While it is believed that U.S. investment abroad has on the whole been economically beneficial to foreign host countries, its benefits to the U.S. economy are less obvious. In fact, I believe that claims made by those who favor a more lenient tax treatment of foreign investment because foreign investment is beneficial to the U.S. economy. are unfounded.

It is true that the accumulated capital outflows of the last 20 years have generated a return flow of income which now—at $6 billion in 1970—exceeds the continuing capital outflow at $4 billion. Yet, measured as a rate of return on the $80 billion stock of capital in place abroad, such income flows compare unfavorably with earnings on domestic capital in the United States. While such income inflows have come over time to provide a helpful credit in the balance of payments, the underlying trade effects are less obvious and more controversial. It is possible that production by U.S. affiliates abroad, particularly in manufacturing, displaces U.S. exports and even domestic sales in the United States. This displacement effect is the more likely since those corporations accounting for the bulk of manufacturing investment abroad are also major exporters. Moreover, sales of manufacturing subsidiaries abroad are now two to three times the level of U.S. exports of manufactured products. It should also be recognized that the economic effects of maintaining a share of foreign markets via foreign production are very different from doing so via domestic production and export. One principal difference lies in the effects on labor productivity and shares in national income. Foreign investment may enhance the private profitability of capital, but it is likely to reduce the real wage to U.S. labor as well as the Government's share in the profits.

There are sufficient doubts about the effects of foreign investment on the U.S. economy to lead to the conclusion that the U.S. tax treatment of foreign investment income should be reviewed and reevaluated. This applies especially to deferral, but consideration should also be given to limiting the present credit for foreign taxes to less than 100 percent—incidentally, a proposal which was made by the Carter Commission in Canada a few years ago with respect to the Canadian foreign tax credit.

Such measures, it should be emphasized, would not be incompatible with opposition to trade restriction. I would like to stress the separation of these two issues. Indeed, as I see it, a less generous tax treatment of foreign investment would be supportive of free trade policy. Removal of nonneutral tax incentives would slow the capital outflow, improve the balance of payments, and reduce the need for trade restrictions. Furthermore, removal of tax preferences to foreign investment and even further tightening of such tax treatment is to be preferred to selective capital controls.

In this connection, I would like to say that while I have a good deal of sympathy for title I of the Burke-Hartke bill, I am quite out of sympathy for the remaining part of the bill which has to do with trade restrictions.

To conclude, I would like to add a few words suggesting that much more information be made available on foreign investment. I believe that the American public deserves to know more about the activities of this important segment of its national resources. We presently rely on the Internal Revenue Service statistics of income, and the Department of Commerce's investment survey figures. These figures are selective, incomplete, difficult to reconcile, and frequently only appear after a very long timelag. Statistical data on foreign operations are inadequate compared with that available for domestic production. The major shortcomings in this regard are indicated in the appendix to my paper in the compendium. Thank you, Mr. Chairman.

Representative REUSS. Thank you.

And on that point, if you could perhaps when you correct your testimony indicate some specific way in which Government statistics on the multinational and on foreign investment could be improved—you are quite right, that they are most inadequate—and what would be a good efficient way of getting better statistics, I think then we would be in a position to do something about it.

Mrs. MUSGRAVE. Yes. I have got an appendix to my paper in the compendium which lays out quite a few areas where there are deficiencies.

Representative REUSS. I am aware of that, and that is most helpful. But in addition, if you could suggest an action program for making good wishes come true——

Mrs. MUSGRAVE. You don't want that presented orally?

Representative REUSS. No; when you correct your testimony, perhaps you can add a little memorandum or note which we will then print in the record to remind ourselves to do something about it.

(The information requested was later supplied as follows:)

INFORMATION ON FOREIGN INVESTMENT

The following recommendations are made for improving the published material by Government departments on U.S. investment abroad:

I.—A concerted effort should be made to provide a detailed, comprehensive and unified set of statistics of a kind to permit a more definitive analysis of the nature and role of foreign investment and to shed light on the foreign and domestsic taxes which apply to it.

II.—For this purpose, an ad hoc inter-departmental committee should be established with representatives from the Department of Commerce and the Treasury as well as other interested agencies. There should be strong representation by experts outside government who are familiar with this field. The committee should report back to the Joint Economic Committee within, say, a six month period.

III.—The Internal Revenue Service should provide improved data (as indicated below) on an up-to-date basis. This data should be made available well in time for consideration in subsequent tax revisions involving foreign investment income. Among the general areas for improvement, the following are suggested:

1. The same degree of detail should be required on Form 2952 for the controlled foreign corporation as for the domestic corporation with respect to both the income statement and balance sheet data.

2. Certain balance sheet data should be required of foreign branches as it is for the controlled foreign corporation. This should be possible since foreign branches must produce such data for purposes of foreign taxes.

3. All data shown in supplementary reports on foreign income should be classified according to the country where taxes were paid. This applies to foreign branches, subsidiaries as well as the Western Hemisphere Trade Corporations.

4. Information regarding the special status corporations (less-developed country corporations, corporations operating in the U.S. possessions, etc.) should be shown separately and in detail.

5. The nature of foreign taxes paid should be indicated—e.g. whether central or local, profits taxes or withholding taxes. Furthermore, it should be clearly indicated what taxes apply to which income (branch or subsidiary profits, dividends, past or current income, etc.).

6. Footnotes to the published material should clearly specify and define the magnitudes shown. Thus it should be made clear in all cases whether profits, dividends and other income items are net of foreign taxes or whether they are grossed up and if so by what foreign taxes and by how much.

7. Inasmuch as most foreign investment is undertaken by the very large U.S. corporations, any classification by asset size of parent company should show breakdowns above the $50 or even $250 million asset size.

8. Supplementary reports to the Statistics of Income (Corporation Income Tax Returns) on foreign income should be published more regularly and promptly than heretofore. At present there appears to be a six- or seven-year time lag.

IV.—The Department of Commerce should provide much more information regarding the business activities of foreign affiliates of U.C. corporations. Hitherto the emphasis in the published material (Survey of Current Business) has been on the balance of payments aspects of the investment. The following suggestions are indicative of the improvements which should be made:

1. Statistics showing sales of foreign affiliates abroad (in the country of investment and to third countries) and to the United States as well as their transactions with the parent companies should be published on a more regular basis. This information is at present only infrequently published and then after a long time lag.

2. Careful studies of rates of return on foreign investment should be made by the Office of Business Economics itself rather than, as at present, to show them in graphical form as computed by the National City Bank of New York. These rates of return estimates should be shown before and after foreign and domestic taxes and the computations explained in detail.

3. Information should be requested and provided to permit the relationships between (a) total sales of U.S. affiliate, (b) export sales from the U.S. parent to the subsidiary, (c) other export sales of the U.S. parent and (d) similar exports of U.S. corporations without investments abroad, to be studied over a period of years for the same subsidiaries.

4. All the data submitted on the questionnaires which the Department of Commerec requires of U.S. corporations with investments abroad should be processed such that computerized analyses may be made. This is of particular importance with regard to the development of individual subsidiaries and foreign branches over time.

5. The OBE should make a study of the rather large apparent discrepancies between their data and that presented in the IRS statistics on foreign income.

6. Earnings figures should be shown separately for foreign subsidiaries and branches and both before- and after-foreign taxes.

7. Periodically a more detailed industrial classification should be shown both for the parent and the foreign subsidiary.

8. In some instances a more detailed country breakdown would be helpful. This is so, for instance, for "other Western Hemisphere" and the Middle East.

Representative Reuss. Mr. Brown.

Representative Brown. Mrs. Musgrave, that was very interesting testimony, and very impressive.

I would like to go back to Mr. Erickson's testimony and ask just one question in connection with it.

Assuming the removal of the oil depletion allowance or the other depletion allowances, do you have an estimate of the cost to the consumer of what would happen to the cost of the product of the consumer of various domestic products?

Mr. Erickson. Well, that is a very difficult question to answer, because it is not solely determined by changes in the tax policies. That also depends upon the action that the President takes with regard to oil imports.

Representative Brown. Let's take the control and everything else and ask the question with relation to that one fact.

Mr. Erickson. In other words, what you want to do is maintain——

Representative Brown. I don't want to do anything; I am just asking a question, and I would like to get an answer.

Mr. Erickson. In one case the cost would be zero, if we allowed more imports to come in.

If we could maintain current oil prices and eliminate the depletion allowance, we would meet a smaller fraction of our domestic needs

with domestic production under that situation. If we try and meet the same fraction of domestic needs with domestic production, and eliminate the depletion allowance, my feeling is—and I apologize here, because I don't have very good numbers—but my feeling is that the price of oil would have to go up substantially, perhaps as much as 15 or 20 percent.

Representative BROWN. And what would that do to consumer prices, let's say gasoline, at the pump?

Mr. ERICKSON. That is again a weighted average of domestic and foreign outlets. For the purposes of discussion let's just assume a 15 or 20 percent increase.

Representative BROWN. In other words, would there be the same percentage increase as the rise of crude?

Mr. ERICKSON. It would be less, because U.S. crude does not account for 100 percent of U.S. needs. But it might be as high as 10 percent.

Representative BROWN. What could you think would be the impact, if we add that, and leave the tax on gasoline for the highway trust fund, all the State and Federal taxes on gasoline? Are we getting the price of gasoline up to where we have an impact upon the automobile industry and all these other things? I guess really what I am pursuing here is the point that Mr. Leontief raised, that it is very difficult—and you just confirmed it by your response, because you said if we do that we ought to change our import arrangements and so forth—that any of these adjustments are going to have impacts and echos down through the economic structure that are a little hard to assess. But dare we as Members of Congress, I guess, make these changes without making a thorough assessment, or recommend these changes without making a thorough assessment of the impact of it on down through the economic structure?

Mr. ERICKSON. My feeling is, yes, you can. And in part that is because—although I sympathize very much with what Mr. Leontief has said, he is outlining a very ambitious task, and we ought to be able to look at the economy first.

Representative BROWN. Are you suggesting that they are not significant, or that they are significant, but worthy of the risk, or what are you suggesting? This is really what I am asking.

Mr. ERICKSON. I am suggesting that they are very difficult to assess, that it is necessary to make policy on the basis of what we know. the first round effects, and then experimentally just use the rudder. as Mr. Leontief suggests, as the record begins to develop, as to what the consequences of the tax policies are.

Representative BROWN. Would you accept that, Mr. Leontief?

Mr. LEONTIEF. Yes. We can't stop working policies decisions while getting background information.

Representative BROWN. That is hardly what I suggested, but I am asking, whether or not we make a thumbnail estimate of what is going to happen, let's just say, in gasoline prices, and drop it there, or should we try to get somewhat more precise information about the impact?

Mr. LEONTIEF. After the preliminary estimates are made, I think that most likely my recommendation would be to eliminate the depletion allowances.

The adjustment to make a change would be very similar to that which we had in the case of taxi fares in New York City. The taxi

driver pays $50,000 to get a badge. They said that if you reduce the fares, the prices of the badges will go down, and the taxi industry will have a capital loss. No doubt about it. Whenever we have changes in taxes some incomes are bound to change; and since net income is often capitalized, there will be some capital losses.

This is unavoidable and in my opinion fully acceptable price of any change in the existing income distribution.

Representative BROWN. I resist getting into the subway comparison, that is the point I am trying to make. I think the bus system and the subway system and the use of private automobiles relate to what you are doing in the way of taxi fares, and I am not sure that I would be as casual about the changes in terms of their impact on the other parts of our economy, and even ecology.

If you have further statistics, however, Mr. Erickson, I would be pleased to have them. And I think it would be helpful if you could summit them. In other words, this is an interesting statement, but it doesn't have very much in the way of substance in it in terms of figures. And I would like to have a statement if I could that would include some figures that include some of the impacts and the echo effect, as was the case with Mrs. Musgrave's statement.

Mr. ERICKSON. The most specific thing I can say at the moment, sir, is that the only previous quantitive work that I know of that deals with the impact of the depletion allowance, and the other special tax provisions that relate to the depletion allowance on U.S. domestic petroleum expiration and reserve holding and production activity by the oil industry, seriously underestimates the effect of the depletion allowance, and I believe that if we remove the depletion allowance and the other special tax provisions, we would get a much larger impact on the industry than the work that is now available suggests. I am at work trying very hard to do a better estimate, but it is something that probably won't be available for some months.

Representative BROWN. If you have anything like that it might be very helpful. I don't have any oil producers or importers or wildcatters or anything else, all I have got is consumers in my area, and I am a little reluctant—Mr. Leontief discussed the political impact—I am reluctant as a political matter to suggest to one of my consumers that the price of oil or natural gas or anything else at the pump, the consumer level, ought arbitrarily to be raised 15 or 20 percent over whatever the figure is, plus the impacts that that might make on some other things such as the use of the automobile or the switch from oil to gas or oil from coal and so forth, without having some better reading of what those impacts are.

I think this is a popular course in a lot of people's mind, because we think in terms of H. L. Hunt—he doesn't know whether that is where he makes his money or not—but whoever it is being much richer than anybody need to be or deserves to be in terms of our Puritan effort but at the same time it is a little bit like the inclusion of municipal bonds. The people that are going to pay that difference are a lot of little people around the country who pay the taxes on municipal services, and the people are going to pay the difference on the depletion allowance, it seems to me, are going to be the people who pay a heck of a lot more for gas and oil consumption. And I am just not altogether sure that because I maybe don't throb to H. L. Hunt, that we should do that sort

of cavalierly, and then look at the impact on all the little folks in my district who neither drill for oil or crack it or do anything else with it except use it in their automobiles and their home heating.

That is all I have, Mr. Chairman.

Representative REUSS. Mr. Conable.

Representative CONABLE. You have given us a discussion on an empirical basis here of oil depletion. I wonder if you would like to relate it to the percentage depletion of the other 116 different minerals. What you say here would not have the same philosophical impact on other minerals as on oil, would it?

Mr. ERICKSON. No. I think if you took the strict logic of what I say, and if the principal rationale for percentage depletion is national security with special references to energy or, say, strategic minerals, it would be very difficult to make a national security argument for, say, depletion on gravel, or——

Representative CONABLE. Depletion is a great symbol here when we are talking about tax reform. I recall when we were working on the 1969 act we discovered that there were four areas of some special preference in the oil industry.

One had to do with the production carveouts, another had to do with the foreign tax credit specially as it applied to the oil industry, another depletion, and the fourth, intangible drilling costs. We didn't do anything with respect to the intangible drilling costs. We did impose roughly a $650 million additional tax burden on the oil industry. I wonder if what you say with respect to depletion would have the same validity with respect to the handling of intangible drilling costs, for instance. I assume it would.

Mr. ERICKSON. Yes; it would.

Representative CONABLE. Because you would approach that in the same emperical way you have approached the depletion question.

Mr. ERICKSON. Absolutely.

Representative CONABLE. You can make a pretty good case for intangible drilling costs being every bit as important a preference with almost the same type of impact as depletion itself.

Mr. ERICKSON. It is quite clear that the expensing of intangible costs is a very special and unusual benefit that the oil industry enjoys.

Representative CONABLE. You will be interested to know that the Ways and Means Committee backed off on doing something with intangible drilling costs. Apparently—I was not one of those who favored it—but apparently because of concern along the lines that Mr. Brown was mentioning here, that they didn't really know what it was going to do to the consumers, and they felt that it put that degree of additional burden on the oil industry, and they had just better not be going too far if it was going to have a price raising impact as a result of passing on these extra costs to the consumer. We tend to be extremely pragmatic and quite cautious here in approaching things of this sort. The extent to which we can study the echo effects is certainly a relevant political question anyway.

Representative BROWN. Would you yield just a minute?

I think even without the echo effect one has to ask whether a 50-percent increase in the price of gasoline as an example balances whateven reduction in taxes the individual consumer gets by having somebody who is benefiting from an oil depletion allowance pay more

taxes. You see, it isn't just the echo effect, it is that tradeoff. And it is sort of like that ad about the bumper, you get your insurance costs reduced 15 percent by making the automobile have a tougher bumper on it, but for most of us that tougher bumper is going to cost a hell of a lot more than we get reduced in our insurance bill because the car has a tougher bumper.

Now, who is kidding whom here? The risk of death, of course, has an impact. The risk of death is significant, and we have to worry about that, or injury. But when we talk about costs, what is the tradeoff?

Representative CONABLE. I agree this is just a good example of the extent to which the process of Government is one of balancing. Of course, it is desirable to know what you are balancing. And what you say is perfectly true, that in most cases we don't have the faintest idea, we just have some guesstimates about what we are balancing.

And it really is not very encouraging for the public to know the extent to which we are guessing in these things as we go through the process of legislating about things having a direct impact on the public.

I would like to repeat what my colleague here said about Mrs. Musgrave's paper. I found it a fascinating paper. I find that I have been altogether too simplistic in my views of the foreign tax credit. And I am interested in it from a number of points of view.

I would like to ask Mrs. Musgrave if we can afford to ignore competitive factors here. Have you made any study of how our handling of foreign tax credits compares to other countries? We hear a good deal about the increasing failure of American competition with other countries. And, of course, what we do here will have a competitive impact. The fact that we would get a bigger return in our domestic market, for instance, by domestic contributions, doesn't necessarily mean that we should put ourselves at a competitive disadvantage in the more rapidly expanding markets abroad. I am wondering if you have considered this aspect carefully?

Mrs. MUSGRAVE. I think that we must be careful to distinguish here between competitiveness and profitability. Increasing somewhat overall taxes on foreign investment will certainly reduce its profitability. This, of course, would be the purpose of such a measure—to make it less profitable, and less attractive. But this should be distinguished, I think, from the effect on the price competitiveness of these operations abroad. Profitability can be reduced without necessarily seriously damaging the competitiveness of these investments.

Representative CONABLE. There is some relationship between the two, obviously?

Mrs. MUSGRAVE. There is a limited relationship in that their capacity to expand competitively, to increase their share of the market from internal funds is affected. If taxes are raised this will reduce the amount of internal funds for further expansion. But again this would be the purpose of such a measure—to slow down this rather rapid rate of foreign investment. If one talks to European businessmen, they usually take the position that U.S. investments abroad have an unfair competitive advantage because they have access to a more up-to-date technology, better management know-how, a broader and cheaper capital market. They argue that we already have a very strong edge over their own people.

Representative CONABLE. I note in your statement that you had considerable sympathy for title I of the Hartke-Burke bill.

Would you spell that out a little further? Would you accept it as drawn, or how far would you go in your support of this type of measure?

Mrs. MUSGRAVE. You recall, I said only title I and not the remaining part.

Representative CONABLE. And you said sympathy and not support for it.

Mrs. MUSGRAVE. I am in wholehearted support of the proposal to eliminate deferral. I am more doubtful, perhaps, about the substitution of deduction for the full foreign tax credit. My personal preference might be perhaps for a reduced foreign tax credit rather than a switch to the deduction method. This would be a less severe and perhaps a compromise emasure which would not go as far as the introduction of the deduction method.

Representative CONABLE. Have you made any study of the probable impact of DISC and the tax deferrals implicit in that?

Mrs. MUSGRAVE. I felt that the DISC proposal was a very unfortunate piece of legislation. I think that what we needed to do here was to tighten up on the tax treatment of foreign investment in order to put exports from this country in a relatively more profitable position vis-a-vis production abroad, instead of which we extended the deferral provision from foreign investment to the DISC corporations. And I felt that it should have been done by tightening up on the most serious competition to foreign exports which comes, I think, from foreign manufacturing investment.

Representative CONABLE. But isn't it true that in some marginal cases DISC would discourage the formation of foreign subsidiaries, and put instead some emphasis on the maintenance of domestic production?

Mrs. MUSGRAVE. It is quite true that it tends to even up to tax advantages given to foreign investment with the tax treatment given to export production in this country; that is quite true, because it extends the deferral privilege from the foreign corporation to the domestic export corporation. But I think that the same effect could be had by eliminating deferral for foreign investment, thus making it relatively more attractive to produce in this country rather than to go abroad, without the unfortunate loss of tax equity which results from the extension of deferral to the DISC corporations.

Representative CONABLE. Then it would be your position that while DISC might have some marginal impact of a favorable nature, that the price is just too high for that type of approach to the problem; is that it?

Mrs. MUSGRAVE. Yes, I think so.

Representative CONABLE. Thank you very much, Mr. Chairman.

Representative REUSS. That is a very interesting exchange, Mrs. Musgrave, with Representative Conable just now. It is so true throughout our tax system that we frequently think the best way to cure a loophole is to create another loophole; for example, we have a loophole which produces hyperthyroid foreign investment at the expense of exports, so then we create a locphole which accentuates exports. If we keep on this way, the foreign investment people will be back in a year or two saying, "Do more for us to repair the deficiency."

For example, we put in a so-called individual income marital deal in the income tax 25 years ago, and it then turned out that that was rough on single people, unfair. So instead of getting rid of the original loophole, we are now fussing around with further loopholes to fix up single people. We tried one, we went a little too far, and now we are trying to patch that up. The exchange therefore seems to me a good note on which to conclude this jolly session.

Let me ask, however, all of the witnesses an overall question. Defenders of the Federal tax status quo make a number of points. First, they say the Federal income system really doesn't benefit the rich in any disproportionate way.

Second, they say that recent changes in the tax laws have not primarily benefited corporations and business.

And third, they make the point that there really isn't any significant revenue available in pursuing tax reforms.

Would any of you like to comment on this?

Mrs. Musgrave.

Mrs. MUSGRAVE. Yes; I would very much like to comment on that, Mr. Chairman, because I think that in the public mind there has been an unfortunate exaggeration as to the revenue implications of tax refrom. I, for one, am very enthusiastic about tax reform and I share your strong feelings about the inequities which are in our present income tax.

However, the unfortunate fact of life is that any realistic income tax reform is not going to generate the additional tax revenue that we are going to need, let's say, by 1975 if we are to finance most of the new programs which are being talked about. I think that the public has to be prepared for greatly expanded revenue needs.

I believe tax reform to be important in terms of achieving a more equitable distribution of the tax burden. Furthermore if tax equity is improved, taxpayers will be ready to bear a heavier burden necessitated by increased expenditure programs. Increased taxes are more palatable if people are comfortable about the equity of the tax. While tax reform is terribly important, we mustn't exaggerate the revenue producing potentialities of an income tax reform.

Representative REUSS. If that position is right, if the gap between needed expenditures and foreseeable revenues even after tax reform is such that it becomes apparent that tax reform by itself can't do it alone—and I happen to agree with you on that—that if anything accentuates the need for tax reform, does it not? Because if we are going to need to raise tax brackets, or to put on a surcharge, there really is going to be a taxpayers revolt when people are asked to pay a surcharge on an existing tax system which is full of holes.

Mrs. MUSGRAVE. I fully agree, Mr. Chairman.

Representative REUSS. If anything doesn't it make the need for tax reform more imperative?

Mrs. MUSGRAVE. Yes.

Representative REUSS. We are most grateful, Mr. Erickson, Mr. Leontief, and Mrs. Musgrave for your contribution to our deliberations.

We have now concluded our series of hearings, for the present, at least, on tax reform, and we stand in adjournment.

(Whereupon, at 12:55 p.m., the committee adjourned, subject to call of the Chair.)

APPENDIX

TAX REFORM RESEARCH GROUP,
Washington, D.C., September 11, 1972.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee, U.S. Congress,
Washington, D.C.

DEAR SENATOR PROXMIRE: On July 21, 1972, your Committee heard testimony from Treasury Under Secretary Edwin S. Cohen. Unfortunately, his statement was incomplete and possibly misleading.

Mr. Cohen told your Committee: "I mean only to stress that substantially all those with high adjusted gross income are paying heavy amounts of taxes. . . ." This is less than candid. As Congressman Henry Reuss pointed out to Cohen, "adjusted gross income is a lovely Treasury term that deliberately excludes those very loopholes we're talking about." It was Mr. Reuss' skillful questioning which finally forced Cohen to concede that "the use of adjusted gross income as a measurement here has great defects."

A second serious defect in Mr. Cohen's presentation was the way he showed the distribution of tax preference benefits by income class. (See his Appendix E). This breakdown conveniently overlooked the number of taxpayers in each income class. Thus, for example, Mr. Cohen's data showed that taxpayers in the $10–15,000 income group receive $230 million in benefits from capital gains treatment while taxpayers in the $100,000+ group receive $2.9 billion—a ratio of 10:1, which is inequitable enough. But the inequity is actually much worse than Cohen would admit. The 9% of all taxpayers in the $10–15,000 group averaged only $16.31 in benefits from the capital gains loophole, while the 1/10th of 1% of all taxpayers in the $100,000+ group averaged over $38,000 each.

Enclosed are computations of average benefits received by individual taxpayers in each income class from the various tax preferences listed by Mr. Cohen. Also enclosed is a letter published in the Washington Post showing the defects in his Adjusted Gross income statistics. Without this information, the public and the legislators that will be considering tax reform next year may be misled by Under Secretary Cohen's statement. Therefore we respectfully request that this information be included in the hearing record following the Under Secretary's presentation.

Very truly yours,

THOMAS H. STANTON, *Director,*
Tax Reform Research Group.

APPENDIX D

EFFECT OF SELECTED TAX PROVISIONS

[In millions of dollars]

	Calendar year 1971		
	Corporations	Individuals	Total
Exclusion of benefits and allowances to Armed Forces personnel		650	650
Exemption for certain income earned abroad by U.S. citizens		50	50
Exclusion of income earned by individual in U.S. possessions		10	10
Western Hemisphere trade corporations	75		75
Exclusion of gross-up on dividends of less-developed country corporations	55		55
Deferral of income of controlled foreign subsidiaries	165		165
Exclusion of income earned by corporations in U.S. possessions	80		80
Farming: Expensing and capital gain treatment	50	790	840
Timber: Capital gain treatment for certain income	125	50	175
Expensing of exploration and development costs	260	65	[1] 325
Excess of percentage over cost depletion	785	200	985
Capital gains treatment of royalties on coal and iron ore	5		5
Investment credit	1,495	305	[2] 1,800
Depreciation on buildings (other than rental housing) in excess of straight line	320	160	480
Asset depreciation range	600	100	[3] 700
Dividend exclusion		300	300
Capital gains: Corporation (other than agriculture and natural resources)	380		[4] 380
Bad debt reserves of financial institutions in excess of actual	400		[5] 400
Exemption of credit unions	40		40
Deductibility of interest on consumer credit		1,800	1,800
Expensing of research and development expenditures	545		545
$25,000 surtax exemption	2,300		2,300
Deferral of tax on shipping companies	10		10
Rail freight car amortization	45		[6] 45
Deductibility of interest on mortgages on owner-occupied homes		2,400	2,400
Deductibility of property taxes on owner-occupied homes		2,700	2,700
Depreciation on rental housing in excess of straight line	300	200	500
Housing rehabilitation	10	15	25
Disability insurance benefits		155	155
Provisions relating to aged, blind, and disabled:			
Combined cost for additional exemption, retirement income credit, and exclusion of OASDHI for aged		3,250	3,250
Additional exemption for blind		10	10
Sick pay exclusion		120	120
Exclusion of unemployment insurance benefits		800	[7] 800
Exclusion of workmen's compensation benefits		320	[7] 320
Exclusion of public assistance benefits		65	65
Net exclusion of pension contributions and earnings:			
Plans for employees		3,650	[7] 3,650
Plans for self-employed persons		250	250
Exclusion of other employee benefits:			
Premiums on group term life insurance		500	500
Deductibility of accident and death benefits		30	30
Medical insurance premiums and medical care		2,000	2,000
Privately financed supplementary unemployment benefits		5	5
Meals and lodging		170	170
Exclusion of interest on life insurance savings		1,100	1,100
Deductibility of charitable contributions (other than education)		3,200	3,200
Deductibility of medical expenses		1,900	1,900
Deductibility of child and dependent care expenses		30	[8] 30
Deductibility of casualty losses		165	[7] 165
Excess of standard deduction over minimum		700	700
Capital gains: Individuals		5,600	[4] 5,600
Pollution control amortization	15		15
Additional personal exemption for students		550	550
Deductibility of contributions to educational institutions		275	[7] 275
Exclusion of scholarships and fellowships		110	[7] 110
Exclusion of certain veterans' benefits		700	700
Exemption of interest on State and local debt	1,800	800	2,600
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes)		5,600	5,600

[1] Considered in isolation this estimate would be $800,000,000. However, if considered in conjunction with percentage depletion the $325,000,000 gives a more accurate picture of the revenue effect.

[2] Effective for only a part year in calendar hear 1971. The full-year effect would be $3,300,000,000

[3] First-year effect, 2d-year effect would be $1,700,000,000. Thereafter builds up for a period of years.

[4] Assumes present restriction on capital losses is retained.

[5] This will decline over time as present law becomes fully effective.

[6] The estimate appears only because the investment credit is effective for only a part year. It will disappear when the investment credit is fully effective.

[7] Not comparable with previous estimates due to revised and/or new sources of data and improved estimating methods.

[8] The liberalized child care deductions which become effective in calendar year 1972 would increase the estimate to $175,000,000.

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APPENDIX E

ESTIMATED DISTRIBUTION OF SELECTED ITEMS OF TAX PREFERENCES OF INDIVIDUALS, BY ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1971

[In millions of dollars]

Adjusted gross income class	Exclusion of benefits and allowances to Armed Forces personnel	Exemption for certain income earned abroad by U.S. citizens	Exclusion of income earned by individuals in U.S. possessions	Farming, expensing and capital gains treatment	Timber, capital gains treatment for certain income	Expensing of exploration and development costs	Excess of percentage over cost depletion	Investment credit	Depreciation on buildings (other than rental housing) in excess of straight line	Asset depreciation range	Dividend exclusion	Deductibility of interest on consumer credit
0 to $3,000	15			20			1	3			5	1
$3,000 to $5,000	120	1		55	2	1	2	16	3	2	13	44
$5,000 to $7,000	175	4	1	80	2	3	8	27	5	4	17	64
$7,000 to $10,000	180	6	1	120	2	2	6	41	11	6	29	165
$10,000 to $15,000	115	7	2	155	4	4	12	51	18	12	55	435
$15,000 to $20,000	28	16	3	90	2	4	12	32	12	9	46	380
$20,000 to $50,000	13	15	3	170	9	16	50	73	47	37	99	620
$50,000 to $100,000	3	1		55	8	14	43	33	28	23	27	59
$100,000 and over	1			45	21	21	66	29	36	7	9	12
Total	650	50	10	790	50	65	200	305	160	100	300	1,800

APPENDIX E—Continued

ESTIMATED DISTRIBUTION OF SELECTED ITEMS OF TAX PREFERENCES OF INDIVIDUALS, BY ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1971—Continued

[In millions of dollars]

Adjusted gross income class	Deductibility of interest on mortgages on owner-occupied homes	Deductibility of property taxes on owner-occupied homes	Depreciation on rental housing in excess of straight line	Housing rehabilitation	Disability insurance benefits	Provisions relating to aged, blind, and disabled		"Sick pay" exclusion	Exclusion of unemployment insurance benefits	Exclusion of workmen's compensation benefits	Exclusion of public assistance benefits	Net exclusion of pension contributions and earnings	
						Combined cost for additional exemption retirement income credit, and exclusion of OASDHI for aged	Additional exemption for blind					Plans for employees	Plans for self-employed
0 to $3,000					35	805	1	2	65	15	25	45	
$3,000 to $5,000	27	41	4		40	750	2	13	110	28	20	145	7
$5,000 to $7,000	81	84	6	1	25	420	2	16	110	41	15	230	10
$7,000 to $10,000	276	263	14	1	30	585	2	32	185	69	5	535	13
$10,000 to $15,000	719	642	22	2	10	245	1	19	230	83		995	22
$15,000 to $20,000	543	505	15	1	5	125	1	20	65	39		685	18
$20,000 to $50,000	621	788	59	6	6	215	1	16	30	38		750	96
$50,000 to $100,000	101	240	35	3	3	70		2	5	6		175	71
$100,000 and over	32	137	45	1	1	35				1		90	13
Total	2,400	2,700	200	15	155	3,250	10	120	800	320	65	3,650	250

APPENDIX E—Continued

ESTIMATED DISTRIBUTION OF SELECTED ITEMS OF TAX PREFERENCES OF INDIVIDUALS, BY ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1971—Continued

[In millions of dollars]

Adjusted gross income class	Exclusion of other employee benefits										
	Premiums on group life insurance	Deductibility of accident and death benefits	Medical insurance premiums and medical care	Privately financed supplementary unemployment benefits	Meals and lodging	Exclusion of interest on life insurance savings	Deductibility of charitable contributions (other than education)	Deductibility of medical expenses	Deductibility of child and dependent care expense	Deductibility of casualty losses	Excess of standard deduction over minimum
0 to $3,000	5		25		2	5	3	5	1		0
$3,000 to $5,000	20	1	80		14	20	31	100	7	5	3
$5,000 to $7,000	30	2	125	1	22	35	82	205	12	10	15
$7,000 to $10,000	75	5	300	1	35	85	225	325	5	30	100
$10,000 to $$15,000	135	8	550	2	35	205	467	470	3	40	415
$15,000 to $20,000	95	6	380	1	25	185	364	311	1	20	115
$20,000 to $50,000	105	6	415		30	420	716	360	1	30	50
$50,000 to $100,000	25	1	95		5	80	426	90		20	2
$100,000 and over	10	1	30		2	65	886	35		10	
Total	500	30	2,000	5	17	1,100	3,200	1,900	30	165	700

APPENDIX E—Continued

ESTIMATED DISTRIBUTION OF SELECTED ITEMS OF TAX PREFERENCES OF INDIVIDUALS, BY ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1971—Continued

[In millions of dollars]

Adjusted gross income class	Capital gains: Individuals	Additional personal exemption for students	Deductibility of contributions to educational institutions	Exclusion of scholarships and fellowships	Exclusion of certain veterans' benefits	Exemption of interest on State and local debt	Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes
0 to $3,000	30	1	----------	6	30	5	4
$3,000 to $5,000	60	17	3	26	95	----------	56
$5,000 to $7,000	70	40	7	28	110	----------	88
$7,000 to $10,000	150	101	20	22	130	5	361
$10,000 to $15,000	230	182	58	15	220	10	772
$15,000 to $20,000	210	92	70	10	70	20	772
$20,000 to $50,000	960	47	90	3	41	100	1,713
$50,000 to $100,000	920	54	20	----------	3	300	906
$100,000 and over	2,970	16	7	----------	1	360	928
Total	5,600	550	275	110	700	800	5,600

Note: Presented by the Honorable Edwin S. Cohen, Under Secretary of the Treasury, in testimony before the Joint Economic Committee, Congress of the United States, July 21, 1972.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

APPENDIX E (WHAT IT REALLY MEANS)

WHAT UNDER SECRETARY COHEN DIDN'T TELL US—TAX PREFERENCE BENEFITS PER INDIVIDUAL IN EACH ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1971

[Dollars per return]

Adjusted gross income class	Number of returns per income class	Percent of returns in each income class	Exclusion of benefits and allowances to Armed Forces personnel	Exemption for certain income earned abroad by U.S. citizens	Exclusion of income earned by individuals in U.S. possessions	Farming expensing and capital gain treatment	Timber capital gain treatment for certain income	Expensing of exploration and development costs
$0 to $3,000	18,063,181	24.4	.83			1.11		
$3,000 to $5,000	10,238,897	13.7	11.72	.10		5.37	.20	.10
$5,000 to $7,000	9,410,802	12.7	18.60	.43	.11	8.50	.20	.32
$7,000 to $10,000	12,901,228	17.4	13.95	.47	.08	9.30	.15	.15
$10,000 to $15,000	14,104,611	19.1	8.15	.50	.14	10.99	.28	.28
$15,000 to $20,000	5,541,347	7.5	5.05	2.89	.54	16.24	.36	.72
$20,000 to $50,000	3,596,348	4.8	3.62	4.17	.83	47.27	2.50	4.45
$50,000 to $100,000	351,669	.5	8.53	2.84		156.38	22.75	39.80
$100,000 and over	77,899	.10	12.84			577.66	269.58	269.58

APPENDIX E (WHAT IT REALLY MEANS)—Continued

WHAT UNDER SECRETARY COHEN DIDN'T TELL US—TAX PREFERENCE BENEFITS PER INDIVIDUAL IN EACH ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1971—Continued

[Dollars per return]

Adjusted gross income class	Number of returns per income class	Percent of returns in each income class	Excess of percentage over cost depletion	Investment credit	Depreciation on buildings (other than rental housing) in excess of straight-line	Asset depreciation range	Dividend exclusion	Deductibility of interest on consumer credit	Deductibility of interest on mortgages on owner-occupied homes
$0 to $3,000	18,063,181	24.4	0.06	0.17			0.28	0.06	
$3,000 to $5,000	10,238,897	13.7	.20	1.56	0.29	0.20	1.27	4.30	2.64
$5,000 to $7,000	9,410,802	12.7	.85	2.87	.53	.43	1.81	6.80	8.61
$7,000 to $10,000	12,901,228	17.4	.47	3.18	.85	.47	2.25	14.34	21.39
$10,000 to $15,000	14,104,611	19.1	.85	3.62	1.28	.85	3.90	30.84	50.97
$15,000 to $20,000	5,541,347	7.5	2.17	5.78	2.17	1.62	8.30	68.58	98.00
$20,000 to $50,000	3,596,348	4.8	13.90	20.30	13.07	10.29	27.53	172.40	172.68
$50,000 to $100,000	351,669	.5	122.26	93.83	79.61	65.40	76.77	167.76	287.18
$100,000 and over	77,899	.10	847.24	372.27	462.13	89.86	115.53	154.04	410.78

	Number of returns per income class	Percent of returns in each income class	Deductibility of property taxes on owner occupied homes	Depreciation on rental housing in excess of straight-line	Housing rehabilitation	Disability insurance benefits	Provisions relating to aged, blind, and disabled: Combined cost for additional exemption retirement income credit and exclusion of OASDHI for aged	Provisions relating to aged, blind, and disabled: Additional exemption for blind
0 to $3,000	18,063,181	24.4				1.94	44.57	0.06
$3,000 to $5,000	10,238,897	13.7	4.00	0.39		3.91	73.25	.20
$5,000 to $7,000	9,410,802	12.7	8.93	.64	0.11	2.66	44.63	.21
$7,000 to $10,000	12,901,228	17.4	20.39	1.09	.08	2.33	45.35	.16
$10,000 to $15,000	14,104,611	19.1	45.52	1.56	.14	.71	17.37	.07
$15,000 to $20,000	5,541,347	7.5	91.14	2.71	.18	.90	22.56	.18
$20,000 to $50,000	3,596,348	4.8	219.11	16.41	1.67	1.67	59.78	.28
$50,000 to $100,000	351,669	.5	682.46	99.52	8.53	8.53	199.03	
$100,000 and over	77,899	.10	1758.66	577.66	12.84	12.84	449.29	

APPENDIX E (WHAT IT REALLY MEANS)—Continued

WHAT UNDERSECRETARY COHEN DIDN'T TELL US—TAX PREFERENCE BENEFITS PER INDIVIDUAL IN EACH ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1971—Continued

[Dollars per return]

Adjusted gross income class	Number of returns per income class	Percent of returns in each income class	Sick-pay exclusion	Exclusion of unemployment insurance benefits	Exclusion of workmen's compensation benefits	Exclusion of public assistance benefits	Net exclusion of pension contributions and earnings	
							Plans for employees	Plans for self-employed
0 to $3,000	18,063,181	24.4	0.11	3.60	0.83	1.38	2.49	
$3,000 to $5,000	10,238,897	13.7	1.27	10.74	2.73	1.95	14.16	0.68
$5,000 to $7,000	9,410,802	12.7	1.70	11.69	4.36	1.59	24.44	1.06
$7,000 to $10,000	12,901,228	17.4	2.48	14.34	5.35	.39	41.47	1.01
$10,000 to $15,000	14,104,611	19.1	1.35	16.31	5.88		70.54	1.56
$15,000 to $20,000	5,541,347	7.5	3.61	11.73	7.04		123.66	3.25
$20,000 to $50,000	3,596,348	4.8	4.45	8.34	10.57		208.55	26.69
$50,000 to $100,000	351,669	.5	5.69	14.22	17.06		497.58	201.88
$100,000 and over	77,899	.10			12.84		1,155.33	166.88

[Dollars per return]

Adjusted gross income class	Number of returns per ncome class	Percent of returns in each income class	Exclusion of other employee benefits				Meals and lodging	Exclusion of interest on life insurance savings	Deductibility of charitable contributions (other than education)
			Premiums on group life insurance	Deductibility of accident and death benefits	Medical insurance premiums and medical care	Privately financed supplementary unemployment benefits			
0 to $3,000	18,063,181	24.4	0.28		1.38		0.11	0.28	0.17
$3,000 to $5,000	10,238,897	13.7	1.95	0.10	7.81		1.37	1.95	3.03
$5,000 to $7,000	9,410,802	12.7	3.19	.21	13.28	0.11	2.34	3.72	8.71
$7,000 to $10,000	12,901,228	17.4	5.81	.39	23.25	.08	2.71	6.59	17.44
$10,000 to $15,000	14,104,611	19.1	9.57	.57	38.99	.14	2.48	14.53	33.11
$15,000 to $20,000	5,541,347	7.5	17.14	1.08	68.58	.18	4.51	33.39	65.69
$20,000 to $50,000	3,596,348	4.8	29.20	1.67	115.40		8.34	115.79	199.09
$50,000 to $100,000	351,669	.5	71.08	2.84	270.12		14.22	227.47	1,211.16
$100,000 and over	77,899	.10	128.37	12,84	385.11		25.67	734,40	11,373.56

[Dollars per return]

Adjusted gross income class	Number of returns per income class	Percent of returns in each income class	Deductibility of medical expenses	Deductibility of child and dependent care expenses	Deductibility of casualty losses	Excess of standard deduction over minimum	Capital gains: Individuals	Additional personal exemption for students
0 to $3,000	18,063,181	24.4	0.28	0.06	-----	0	1.66	0.06
$3,000 to $5,000	10,238,897	13.7	9.77	.68	0.49	.29	5.86	1.66
$5,000 to $7,000	9,410,802	12.7	21.78	1.28	1.06	1.59	7.44	4.25
$7,000 to $10,000	12,901,228	17.4	25.19	.39	2.33	7.75	11.63	7.83
$10,000 to $15,000	14,104,611	19.1	33.32	.21	2.84	29.42	16.31	12.90
$15,000 to $20,000	5,541,347	7.5	55.95	.18	3.61	20.75	37.90	16.60
$20,000 to $50,000	3,596,348	4.8	100.10	.28	8.34	13.90	266.94	13.07
$50,000 to $100,000	351,669	.5	255.90	-----	56.87	5.69	2,616.10	153.54
$100,000 and over	77,899	.10	449.29	-----	128.37	-----	38,126.29	205.39

[Dollars per return]

Adjusted gross income class	Number of returns per income class	Percent of returns in each income class	Deductibility of contributions to educational institutions	Exclusion of scholarships and fellowships	Exclusion of certain veterans benefits	Exemption of interest on State and local debt	Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes)
0 to $3,000	18,063,181	24.4	-----	0.33	1.66	0.28	0.22
$3,000 to $5,000	10,238,897	13.7	0.29	2.54	9.28	-----	5.47
$5,000 to $7,000	9,410,802	12.7	.74	2.98	11.67	-----	9.35
$7,000 to $10,000	12,901,228	17.4	1.55	1.71	10.08	.39	27.98
$10,000 to $15,000	14,104,611	19.1	4.11	1.06	15.60	.71	54.73
$15,000 to $20,000	5,541,347	7.5	12.63	1.80	12.63	3.61	139.33
$20,000 to $50,000	3,596,348	4.8	25.02	.83	11.40	27.81	476.32
$50,000 to $100,000	351,669	.5	56.87	-----	8.53	853.00	2,576.06
$100,000 and over	77,899	.10	89.86	-----	12.84	4,621.31	11,912.71

[From the Washington Post, Aug. 1, 1972]

Another Look at Taxes of the Wealthy

On July 22 the Post reported: "Under Secretary of the Treasury Edwin S. Cohen told Congress yesterday that substantially all of the rich are paying huge amounts of federal income tax despite reports to the contrary."

In support of this contention were cited Cohen's statistics that 621 individuals with "adjusted gross income" of more than $1 million in 1970 paid an average tax of "46.4 per cent on gross and 65.3 per cent of net taxable income." (Cohen conceded that three such wealthy individuals paid no federal income taxes at all.)

These statistics conceal much more than they reveal. As Congressman Henry Reuss (D-Wis.) pointed out to Cohen, "adjusted gross income is a lovely Treasury term that deliberately excludes those very loopholes we're talking about."

For example, adjusted gross income does not include tax-free bond income and income sheltered by tax devices such as capital gains, percentage depletion, and accelerated depreciation. Mr. Cohen was saying, in effect, that the wealthy pay substantial taxes on that part of their income not favored by loopholes.

Let's look at the full cost of some of the loopholes in the law today. Percentage depletion (for individuals and corporations) costs the government about a billion dollars a year in lost revenues. (That's close to the combined 1972 budgeted amounts for all of the activities of the Department of State and the entire legislative branch). Accelerated depreciation for individual and corporate machinery and real estate costs well over $3 billion annually (more than the combined 1972 budgeted amounts for the Department of Justice, the Department of Commerce, and the entire federal court system). The individual and corporate tax exemption for state and local bonds costs about $2.3 billion annually (roughly the 1972 budgeted amount for the Environmental Protection Agency). And the individual capital gains subsidy costs about $7 billion annually, or as much as all of the above subsidies put together! (On tax subsidies, see the Joint Economic Committee study, "The Economics of Federal Subsidy Programs").

And most of these subsidies benefit the rich. For example, capital gains is a device which allows speculators and investors to pay much lower tax rates than people who earn the same income from salaries and wages. Only one out of twelve taxpayers reports capital gains, and 75 per cent of the benefits go to the wealthiest 9 per cent of American taxpayers.

Mr. Cohen presented the deceptive figures in an attempt to disparage as "political rhetoric" assertions that the wealthy are under-taxed. In fact, the figures he omitted cogently make the case for tax reform: There is much revenue to be gained by closing loopholes, and many of these excessively favor the wealthy.

To be sure, some of the tax subsidies might be replaced by more carefully designed (and less expensive) direct subsidy programs. But the Treasury Department is treading on thin ice when it bases its opposition to tax reform on misleading statistics such as those reported. Mr. Cohen might well heed the lesson learned by the Defense Department, which suffered a massive credibility gap after trying to justify policy on the basis of incomplete disclosures. The Treasury should think twice before allowing Vietnamization of its tax policy statistics.

Tom Stanton,
Alan Kamin,
Tax Reform Research Group.

Washington.

[From the New York Times, Aug. 29, 1972]

Nixon's Tax Data Disputed in Study

Nader Group Denies Middle Class Benefits Greatly

(By Eileen Shanahan)

Washington, Aug. 28—A tax reform group attacked today, with detailed figures, the recent assertion by the Nixon Administration that the middle class was the group that benefitted most from what are commonly called "tax loopholes."

What the Administration left out of its figures, according to the reform group, was any information about how many taxpayers there were in each income group.

The Administration's figures showed, for example, that persons in the $10,000 to $15,000 income group realized a total of $642-million in tax savings last year

from the section of the tax law that permits deductions of property taxes. Persons in the over-$100,000 bracket realized only about one-fifth as much, or $137,-million.

But there are more than 14 million individuals and families in the $10,000–$15,000 bracket, about 20 percent of all taxpayers, while there are only about 78,000, or less than two-tenths of one percent of the total, in the over-$100,000 category.

DISPARITY REPORTED

Thus, according to the figures released by the reform group, when the benefits of the property-tax deduction are calculated on a per-taxpayer basis, the savings for those in the $10,000–$15,000 bracket averaged $45.52 a year, whereas in the over-$100,000 bracket, the savings averaged $1,758.66.

The disparity created by the special tax treatment of capital gains is even greater, according to the reformers' figures. The middle-income taxpayers in the $10,000–$15,000 class realized an average saving of $16.31 a year from this tax-law provision but those in the over-$100,000 bracket realized an average of $381,125.80.

The study of the impact on individual taxpayers of various tax law provisions was done by the Tax Reform Research Group, an organization created by Ralph Nader.

The organization accused the Nixon Administration of "presenting deliberately misleading statistics to the Congress and the American public in an attempt to undermine the growing pressure for tax reform.

The figures criticized by the reform group were given to the Congressional Joint Economic Committee last month by Edwin S. Cohen, Under Secretary of the Treasury, who is the Administration's chief spokesman on tax policy matters.

The tax reform research group said that the disparity in benefits between middle-income and high-income taxpayers could be dealt with, in part, by converting many of the special tax preferences to credits rather than deductions.

A credit is subtracted from the amount of tax that the taxpayer would otherwise owe and thus $1 of credit is worth $1 of tax savings to anyone, regardless of income bracket.

On the other hand, a deduction is subtracted from the income on which the tax is calculated, and $1 of deduction is worth 14 cents to a person in the bottom tax bracket but 70 cents to a person in the top bracket.

The study by the tax reform group showed that even tax benefits that have been kept in the law primarily out of concern for persons of average income benefit the wealthy more. An example is the tax-free status of the first $100 of dividends received each year by an individual.

DIFFERENCE IN SAVING

According to the reformer's, for persons in the $10,000–$15,000 income bracket, the average tax saving created by this provision was $3.90, whereas in the over-$100,000 bracket, the average saving was $115.53.

The special tax treatment of an investment owned almost exclusively by the wealthy—the tax-exempt bond issued by state or local governments—was said by the group to yield annual tax savings averaging only 71 cents for those in the $10,000–$15,000 bracket and $4,621.31 for those in the over-$100,000 bracket.

The group said the 22 percent depletion allowance for investors in oil and gas wells yielded tax savings of 85 cents for the average person in the $10,000–$15,000 class and $847.24 for the average person in the over-$100,000 class.

The tax reform research group said that its figures were calculated by using the statistics presented by Under Secretary Cohen for 1971, plus treasury figures on the number of taxpayers in each bracket for 1970. The latter figures are not yet available for 1971 but would not change the calculations appreciably, the tax group said.

Tax Reform Research Group Attacks Treasury Department for Deceptive Data

The Tax Reform Research Group charged today that the Treasury Department was presenting deliberately misleading statistics to the Congress and the American public in an attempt to undermine the growing pressure for tax reform. The statistics they attacked were presented in testimony before the Con-

gressional Joint Economic Committee last month by Treasury Under Secretary Edwin S. Cohen.

The Treasury data appeared to show that the distribution of "tax preferences" (i.e. income which is not taxed as heavily because of various exemptions, deductions, or credits) favored primarily the middle income taxpayers. However, with the addition by the Research Group of important omitted statistics regarding the number of taxpayers in each income class, it becomes clear that almost all of the tax preferences favor the highest income taxpayers much more than those in middle income brackets.

For example, the Treasury data showed that the deduction for medical expenses was worth $470 million to taxpayers earning $10–15,000 in 1971 and only $35 million to those earning $100,000 or more. But Mr. Cohen's statistics did not mention that there were approximately 14 million taxpayers in the first group and only 78,000 in the latter. This means that the medical expense deduction was worth an average of only $33 to each taxpayer earning $10–15,000 while those taxpayers earning $100,000 or more—the wealthiest 1/10 of 1%—received an average of $449 worth of benefits. Although the Treasury data appeared to show that the wealthiest taxpayers received only 7½% of the benefits from this deduction which went to those earning $10–15,000; in fact, the rich received more than ten times the benefits, on a per taxpayer basis.

The more complete data presented by the Tax Reform Research Group showed the Treasury statistics to be similarly misleading for many of the other tax preferences. With regard to some of the preferences, the omission by Treasury of the number of taxpayers in each income group causes the data to greatly understate the disparity in the distribution of loophole benefits.

For example, Treasury data showed that taxpayers in the $10–15,000 group receive $230 million in benefits from capital gains treatment while taxpayers in the $100,000 or more group receive $2.9 billion—a ratio of 10:1. But, in fact, the 19% of all taxpayers in the $10–15,000 group average only $16.31 in benefits from capital gains treatment while the 1/10 of 1% of all taxpayers in the $100,000+ group average over $38,000 each in benefits.

Similarly, the Treasury's figures for charitable contributions show a 2:1 ratio favoring the wealthy from this deduction—$467 million to taxpayers in the $10–15,000 group and $886 million to taxpayers in the $100,000+ group. But, on the average a $10–15,000 income taxpayer gets only $33.11 in benefits while each $100,000+ taxpayer gets an average of $11,373.56. And the tax exemption of state and local bond interest is worth only 71¢ on the average to a taxpayer earning $10–15,000 while to a $100,000+ taxpayer it is worth an average of $4,621.31.

"MIDDLE CLASS LOOPHOLES"

Even some of the tax preferences which have been traditionally thought of as "middle class loopholes" actually benefit the wealthy much more on the average than the middle income taxpayer. For example, Treasury data showed that the deduction for interest on mortgages on owner-occupied homes was worth $719 million to those in the $10–15,000 group and only $32 million to those in the $100,000+ group. But, this averages out to only $50.97 to a taxpayer earning $10–15,000 and $410.78 to a $100,000+ taxpayer.

Similarly, the deduction for property taxes on owner-occupied homes is worth $642 million to the group earning $10–15,000 and only $137 million to the $100,000+ group. But, this is an average of only $45.52 for a $10–15,000 taxpayer while it averages $1,758.66 for the $100,000+ earner—a ratio of more than 35:1 in favor of the rich.

"These statistics," a spokesman for the group said, "really show how great the need for tax reform is. If the Congress instituted a system of flat credits to replace the various exemptions, deductions, and credits that currently exist, much of the disparity shown here could be eliminated."

Tax reformers have long advocated credits in lieu of present tax preferences. Under such a system each taxpayer regardless of income level would derive the same benefit from a tax preference which he takes advantage of—instead of the present system which makes the value of most tax preferences increase as the taxpayer's income goes up.

The Tax Reform Research Group explained that its corrected version of the Treasury tables was not accurate to the last decimal place. Since the Treasury has not yet released certain tax statistics for 1971, the 1970 figures had to be used to compute the number of tax returns in each income class. But this discrepancy was expected to have only a small impact on the accuracy of the sta-

tistics present by the Research Group. The figures used by the Group were taken from *Individual Income Tax Returns: Preliminary 1970 Statistics of Income*, published by the IRS in February 1972.

"ADJUSTED GROSS INCOME"—ANOTHER MISLEADING CONCEPT

The Tax Reform Group also pointed out that the statistics Mr. Cohen presented to the Joint Economic Committee were misleading on another count. By using figures for "adjusted gross income" rather than those for gross income the Treasury omits from the data the effects of many of the loopholes which tax reformers most vehemently attack, they said. Accelerated depreciation, oil percentage depletion, and the exemption of interest from state and local bonds, for example, all act to decrease the gross income of those who benefit by them before calculation of their "adjusted gross incomes."

Thus, in his attempt to show that the rich pay heavy taxes, Mr. Cohen completely ignores those loopholes which act to decrease the taxpayer's gross income before calculating his AGI. "This is the kind of statistical analysis we have come to expect from the Treasury," one researcher remarked. "They frequently present only half of the story—the half which supports their point of view."

Thomas H. Stanton, Director of the Tax Reform Research Group, commented: "With its deceptive manipulation of information, the Treasury Department is creating a serious credibility gap. It will be a sad day when the Treasury actually does tell the truth, but nobody believes them."

[From the Congressional Record, 92d Cong., 2d Sess., Vol. 118, No. 132, Washington, Wednesday, August 16, 1972]

TAX REFORM—TESTIMONY OF SENATOR HATFIELD BEFORE REPUBLICAN PLATFORM COMMITTEE

Mr. HATFIELD. Mr. President, this week I submitted testimony to the Platform Committee of the Republican Party on the issue of tax reform. Because of the timely interest of this subject, I ask unanimous consent that this testimony be printed in the RECORD.

There being no objection, the testimony was ordered to be printed in the RECORD, as follows:

SIMPLIFORM: HOW TO SIMPLIFY AND REFORM OUR TAX SYSTEM

(By Senator Mark O. Hatfield)

Mr. Chairman, I would like to preface my testimony by expressing my appreciation to you and your committee members for allowing me to present my thoughts on one aspect of federal income taxes before you today.

Mr. Chairman, we are all familiar with two aspects of our Federal income tax system which are wrong: it is much too complicated and it is not as fair as it could and should be.

It is horribly complicated and confusing when:

Nearly $2 billion are spent in filling out tax forms, and even then the more than 50,000 "tax preparers" cannot get it right most of the time. In fact, former Treasury Secretary John Connally pointed out that a Treasury survey of such returns found 97% inaccurate.

The income tax form has grown from 18 lines to 63 lines, not counting the multitude of additional schedules. And the book of instructions is so complex that even college graduates cannot understand all of it.

A Treasury official (quoted in the Washington Evening Star News, August 4, 1972), stated that "if we don't simplify taxes, the system will fall of its own weight . . . the seeds of decay are growing."

As a matter of fact, even the Internal Revenue Service with its 70,000 employees cannot complete the tax forms properly any more. In a test by the Wall Street Journal (April 13, 1972) five different IRS offices came up with five different tax results for the same taxpayer.

When the tax system has reached this point, we must all admit it is in a shambles. Even acknowledged tax experts say "they are knowing less and less about more and more." From a one paragraph amendment to the Constitution, the income tax has emerged as a hydra-headed monster that now takes more than a 6-foot bookshelf to contain its laws and regulations.

We also know that the tax system is not fair: a Harris Poll last year found that 69% of the public had joined the "tax revolt"—up from 43% two years earlier. The tax system is unfair when:

21,317 persons in 1969 with incomes over $20,000 paid no taxes whatsoever, including 56 millionaires who paid no taxes at all.

People with income under $2,000 paid one-half of this in all forms of taxes (federal, state, and local), as computed by the U.S. Census Department in its 1970 Census, at the same time that one multi-millionaire paid $500 and another paid $4500 in federal income taxes, which is less than they make in one hour. The rest of us end up paying about 30% of our income in all forms of taxes regardless of the income level despite the alleged progressive nature of the federal income tax that should rectify all this.

The Congress and the Treasury have tried to correct these admitted deficiencies in the tax system. It was tried in 1954, 1964, and finally in the "Tax Reform Act of 1969." An attempt was made to fill loopholes but more were created. It seems as though an effort was made to achieve reform through complexity but only more complexity resulted. The 1969 Act became so complex it was labeled "The Lawyers and Accountants Relief Act of 1969" by the Assistant Secretary of the Treasury for Taxation. A year after reform still 3000 people with incomes over $30,000 paid no taxes.

We have tried reform through making the tax laws more complicated but only succeeded in the latter. It is now high time we aim for tax reform through simplification to achieve both.

What I am proposing today owes its genesis to many individuals. It is a suggested direction in which I believe we should move and a vehicle for discussion and perhaps improvement. I offer it in anticipation of major tax reform efforts during the next Congress in order that we in the Congress might examine as many of the complexities and implications of our present system as possible—and hopefully produce a better tax system.

I call my approach the "Simpliform" system. This is how it would work.

We must move to a simple gross income tax system eliminating all deductions except the personal exemption. (This resembles state income tax laws in Indiana and Pennsylvania). This would mean more than 90% of our taxpayers could complete their form on a small IBM card using only four lines: total income, gross-tax, credit for personal exemptions, and net tax (or refund) due.

All income flows (wages, salaries, interest, dividends) would be subject to a 10% withholding at the sources. The payers of such income flows would (as now except for interest and dividends) send copies of such withholdings to both the IRS and the taxpayer. At the end of the year the taxpayer would simply atach the withholding forms to his "simpliform" tax card, fill in the four lines, and that would be it.

The mathematics are quite simple: in rough orders of magnitude, in 1972 there is a total personal income tax base of about $914 billion (based on a Brookings Institution study by Drs. Okner and Pechman). A 10% withholding rate across the board would bring in $91 billion, roughly the current yield ($86.5 billion in fiscal 1972). The exemptions would be in the form of a straight dollar "tax credit" of $250 per adult (over 18). (Under a 10% tax rate these tax credits would be equivalent to a $2,500 adult deduction compared to the current $750 deduction under present law). These personal exemptions would reduce the revenue yield by about $28 billion. However, this amount will be more than recouped in the progressive surtax provisions I propose to keep in the income tax base of our tradition of "ability-to-pay". (To raise additional revenue, a surcharge should be made on the actual amount paid, rather than increasing the specific surtax).

It might be asked, why use "tax credits" instead of "deductions" from the total income base? The answer is simple equity: it would give each person the same dollar tax break. Under the present law a person in the 70% tax bracket gets a $525 tax cut for his exemption whereas a person in the bottom 14% bracket only benefits by a $105. My plan gives to each one equally: $250 per adult—18 years old and above. (Children are regarded here as "choices" for parental consumption expenditures in our age of targeted "zero population growth." There is no reason why single or married individuals without children should have to "subsidize" other people's children, which is what the present system does. Obviously poor families are still taken care of under welfare).

Would this "proportional" 10% tax rate system be "progressive" that is, be based on our tradition of "ability to pay"? Yes, in fact, while the present system is supposedly "progressive" it turns out to be "proportional because of loopholes." My system would be "progressive" because of the use of personal credit exemptions. Thus, under my system a family of four would pay no taxes below a level of $5,000. At that point ($5,000) the tax rate would rise from zero and approach 50% at the level of $1 million under my surtax provisions. This is accomplished by a "surtax" of 5% on income between $10,000—$15,000; 10% between $15,000–$20,000; 15% between $20,000–$25,000; 20% between $25,000–$50,000; 25% between $50,000–$100,000; and 30% between $100,000–$500,000; 35% between $500,000–$1,000,000; and 40% on incomes over $1 million. Thus, establishing a top bracket rate of 50% (10% base plus 40% surtax). (At present the actual top rate on upper incomes is not the 70% statutory rate, but is really an average 32%). This surtax would not complicate the system for nearly one-half of all American families have incomes below $10,000 and would hardly be difficult for those above the $10,000 bracket to compute—indeed, it would resemble many state income tax systems in its simple 5% brackets. This is illustrated in the following table:

SIMPLIFORM INCOME TAX SYSTEM

[Assume family of 4: 2 adult tax credits of $250-$500; in thousands of dollars]

Tax bracket (thousands of dollars)	0 to 10	10 to 15	15 to 20	20 to 25	25 to 50	50 to 100	100 to 500	500 to 1,000	1,000 plus
Marginal tax rate (highest)	10 percent	15 percent	20 percent	25 percent	30 percent	35 percent	40 percent	45 percent	50 percent.
Tax (before $500 2-adult credit)	do	$1,000+15 percent above $10,000.	$1,750+20 percent above $15,000.	$2,750+25 percent above $20,000.	$4,000+30 percent above $25,000.	$11,500+35 percent above $50,000.	$29,000+40 percent above $100,000.	$189,000+45 percent above $500,000.	$414,000+50 percent above $1,000,000.
Illustrative tax (on middle of income tax bracket):									
Sample income	$7,500 [1]	$12,500	$17,500	$22,500	$37,500	$75,000	$300,000	$750,000	$2,000,000.
Tax	$250	$875	$1,750	$2,875	$7,250	$19,750	$108,500	$301,000	$913,500.
Average tax rate	3.3 percent	7 percent	10 percent	12.8 percent	19.3 percent	26.3 percent	36.2 percent	40.1 percent	45.7 percent.

[1] No tax on 2-adult family with income $5,000 and below; $7,500 taken as middle of 1st taxable range of $5,000 to $10,000.

Another question might be raised: Would not the "middle income" American lose by eliminating deductions for property taxes, mortgage interests, medical expenses and charitable contributions? No, he would only be treated more fairly. On the average those with incomes below $20,000—85% of all families—will gain by this new system. Under the present law the "middle income" American is really subsidizing the rich. The "middle income" American, say in the 20% tax bracket, gets the benefit of 20 cents on the dollar for his property taxes, interest payments, contributions, etc.—the wealthy get up to 70 cents on the dollar for the same activities. Why should the "middle income" American pay higher taxes so the rich can deduct $70 of a $100 ticket to a Charity Ball when he gets only a 20 cents tax break for each dollar he puts in the church collection plate? Why should he pick up the tab for 70% of the tax and interest payments on a $200,000 mansion? By my system the "middle income" American could get direct relief through special grants or credits for property tax reductions. In addition, the homeowner and rentor would be treated equally. So would those who bother to "itemize" and those who use the standard deduction. Instead of medical deductions favoring the wealthy, he would get better medical care through expanded health insurance programs. Medicare and Medicaid, and federally-funded improved health care delivery systems provided by these tax savings. Let's not complicate our tax system to give "welfare" to the rich when we can get lower property taxes and better health care by a more direct and cheaper method.

How would this "Simpliform" system work in practice for different income groups? The following table may help: (based on a family of four now taking the standard deduction). (I have included the social security "tax" on employee wages to provide a consolidated income and social security tax rate on earned income.)

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Family income	Present system: Income tax	Present system: Social security tax	Present system: Total	Present system: Rate	Present system: Average rate, percent excluding social security	Simpliform: Income tax	Simpliform: Social security tax	Simpliform: Total	Simpliform: Rate	Simpliform: Average rate, percent excluding social security
$2,000	0	$100	$100	5.0	0	0	$100	$100	5.0	0
$4,000	$39	200	239	6.0	1.0	0	200	200	5.0	0
$5,600	271	280	551	9.8	4.8	60	280	340	6.1	1.1
$8,000	672	400	1,072	13.4	8.4	300	400	700	8.75	3.75
$10,000	1,000	450	1,450	14.5	10.0	500	450	950	9.5	5.0
$12,000	1,342	450	1,792	14.9	11.1	800	450	1,250	10.4	6.7
$15,000	1,996	450	2,446	16.3	13.3	1,250	450	1,700	11.3	8.3
$20,000	3,210	450	3,660	18.3	16.1	2,250	450	2,700	13.5	11.3
$25,000	4,636	450	5,086	20.3	18.5	3,500	450	3,950	15.8	14.0
$50,000	14,960	450	15,410	30.8	29.9	11,000	450	11,450	22.9	22.0
$100,000	42,660	450	43,110	43.1	42.7	28,500	450	28,950	29.0	28.5

Note: Present system based on 1971 income tax tables. Social security tax based on a 5-percent tax on first $9,000 income. (Actual 1972=5.2 percent.)

Notice that the "Simpliform" system would *reduce* taxes for all income groups based on combined federal income tax (and/or social security tax payments) and using the standard deduction; lower and middle income groups (using standard deductions) substantially benefit, especially those below $20,000. The overall equivalent yield of "Simpliform" at much lower tax rates is based on the elimination of "itemized deductions" plus the inclusion of all income (half of capital gains, tax-exempt bond interest, etc.) which are now excluded from the tax base.

How would business and entrepreneurs be affected? Full capital gains would be included in our income tax base. (This would require a separate form for the 5% of the population who receive capital gains; for those in mutual funds, capital gains would be reported the same as dividends or other ordinary income and included on the same simple 4-line "Simpliform" requiring no other schedule). But remember the top rate for most Americans would still be well below 25%, which is the rate for most capital gains under the so-called alternative schedule use by most capital gainers, so there would be no direct change. (The highest marginal rate does not go above 25% until $25,000 in income.) (At present capital gains tax rates range between 7–35% but the predominant bulk is at 25%.) For those earning between $50,000–$100,000 the rate would go to only 35%, which is now the maximum rate. For those earning over $100,000, the highest rate would still be 40% until $500,000. But this is more than compensated for by the *reduction* in the top rate of 70% down to 41% on ordinary income for a millionaire. Overall incentives will be increased for business enterprise. Indeed, for a young single executive who now faces marginal income tax bracket rates of 40% by the time he reaches $23,500, he will still be in the 25% tax bracket under "Simpliform." Those just below $50,000 will face only a 30% bracket under "Simpliform," as contrasted to 60% under present law. Incentives thus will be *increased* rather than diminished for rising young executives. And they will not have to waste time worrying about converting ordinary income to long-term gains because all will be called simple income under my system.

Let me now summarize some of the simple arithmetic and actual shift in tax burdens of this proposal:

SENATOR MARK O. HATFIELD, REPUBLICAN PLATFORM TESTIMONY—TAX REFORM

TAX BURDENS AND REVENUES UNDER SIMPLIFORM AND PRESENT SYSTEM

[Taxes in billions of dollars]

Income class (thousands)	Gross income (expanded AGI) 1972 tax base under simpliform [1]		Simpliform		Present system [2]	
	Number of families (thousands)	Gross income (billions)	Tax	Average rate (percent)	Tax	Average rate (percent)
Under $3	5,923	$8.0	0	0	0	0.5
$3 to $5	6,874	27.6	0	0	$0.5	1.7
$5 to $10	19,387	145.0	$4.8	2.5	7.7	5.3
$10 to $15	17,535	216.5	14.9	6.9	18.8	8.7
$15 to $20	10,486	180.3	17.9	9.9	19.4	10.7
$20 to $25	4,954	109.9	14.7	13.4	13.3	12.1
$25 to $50	4,463	142.9	24.9	17.4	20.7	14.5
$50 to $100	625	41.2	10.3	25.0	9.7	23.5
$100 to $500	189	31.4	11.2	35.7	9.2	29.5
$500 to $1,000	6	4.4	1.8	40.9	1.3	30.4
$1,000 and over	3	7.1	3.2	45.1	2.3	32.1
Total	70,445	914.3	103.8	11.4	102.9	11.3

[1] Based on all-inclusive personal income tax base (Okner-Pechman) including full-enclosure of capital gains.
[2] Revenue Act of 1971 applied to 1972 incomes. (Fiscal 1972 yield was $86,500,000,000 initial budget estimate for fiscal 1973 was $93,900,000,000 in tax revenues.)

Note: Under Simpliform those under $20,000 income on the average would benefit compared to the present system. This means 85 percent of families would benefit by Simpliform. (Of course, those above $20,000 who take the standard deduction or small amounts of itemized deductions would also benefit while those families with huge itemized deductions below $20,000 might lose a little.)

In conclusion, it is time to think anew and act anew to solve the mess of our present tax system. It is both too complex and unfair—and attempts at making it more fair have succeeded in making the system only more complex. We have tried the route of filling loopholes and making marginal adjustments. It is time to

"redo" the system from the bottom up. We can do it. We can make a substantial simplification which also brings reform—for the poor, for the elderly, for the business entrepreneur, and for the overburdened and overbothered middle class.

My "Simpliform" approach is a way of fresh "new thinking" about tax reform. I do not know all the answers and my proposals are not yet ready to be carved in granite. Indeed, as of March 1 of this year already 1,149 tax bills have been proposed for consideration by the House Ways and Means Committee. I do not propose to kid you into thinking a bill based on this proposal would sail through the Congress. Time is far too short this session to expect "instant reform" be it simple or not.

But a dialogue should begin. I believe tax reform and simplifying reform are the wave of the future. The President has promised us new legislation on tax simplification and reform next year. The dialogue should begin now so that we will see soon both a simple and fair tax system.

CONGRESS OF THE UNITED STATES,
HOUSE OF REPRESENTATIVES,
Washington, D.C., August 3, 1972.

Senator WILLIAM PROXMIRE,
Chairman, Joint Economic Committee,
Washington, D.C.

DEAR SENATOR PROXMIRE, Enclosed is a copy of a letter from one of my constituents, Mr. Dan Antenen, prepared in response to Mr. I. W. Abel's comments before your Committee. I respectfully request that this correspondence be made a part of your hearing records.

With best wishes, I am

Sincerely,

WALTER E. POWELL,
Member of Congress.

ABEL BLASTS TAX LAWS AS "FRAUD"

Washington (UPI)—The AFL–CIO said Thursday the average American family pays nine times more tax on $10,000 if its income comes from wages than if it comes from investments.

The labor federation—siding squarely with Democratic presidential nominee George S. McGovern in advocating sweeping tax reform—called for an end to what it termed the "legalized fraud" of the laws.

Its position was set forth in a statement filed with Congress Joint Economic Committee by I. W. Abel, president of the United Steelworkers Union and chairman of the AFL–CIO Economic Policy Committee. Abel was unable to appear to present his testimony.

Abel argued that the system is unfair to working people who derive their entire incomes from wages.

If a family of four had an income of $10,000 from wages its federal income tax would be $905, he said. But if the $10,000 was derived solely from investments "the tax would be only $98."

Contentions of the AFL–CIO, as presented the Congress-Joint Economic Committee, that a family of four deriving its income from wages would pay nine times as much tax as a family of that size deriving the same amount—$10,000—from investments deserves some elaboration and refutation.

The term "investments" has such wide application as from houses to stocks and bonds to savings accounts to car washes to hot dog stands, etc., that Mr. Abel's presentation is more imaginary than real.

Aside from an exemption from taxation for the first $100 of dividend income, there is very little else to distinguish investment income from ordinary wage income. To arrive at the minimal tax which the AFL–CIO suggests one would have to place most of his savings in state or municipal bonds. This is comparable to asking "which is farther, to Chicago or by bus?" because the reality of a $10,000 income person risking his marbles for the lower-than-average return of tax-exempt investments is practically nil.

What is true, however, is that the dollar cost of almost everything marketed today is either being pulled up by the extravagance of rags-to-riches easy credit or by beyond-its-income spending by government, or by the cost-push of labor

union demands. Because this cost rise eats away the purchasing power of "dollars" put into investments, the dividend or interest return becomes little more than a bit-by-bit using up of the original value. (Congress has given recognition to this fact in the $100 dividend credit.) Ask the stockholder of any of the major steel companies if the sum total of his after-tax dividend income plus the dollars he could now realize from selling his shares would buy as much goods as had it been spent a dozen years ago. Not by a long shot—and this in Mr. Abel's back yard!

America's businesses have been realizing a diminishing return on invested capital over these same dozen years. If the liberal establishment continues to libel business and promote a poor regard for capital endeavor, this country may have no future other than to shamefully repeat Great Britain's march toward oblivion via low morale, low productivity and countless basic industry and public service strikes.

DAN E. ANTENEN,
Hamilton, Ohio.

STATE UNIVERSITY OF NEW YORK AT ALBANY,
DEPARTMENT OF ECONOMICS,
Albany, N.Y., July 18, 1972.

Senator WILLIAM PROXMIRE,
Chairman, Joint Economic Committee,
U.S. Congress, Washington, D.C.

DEAR SENATOR PROXMIRE: It is my understanding that the Joint Economic Committee is now holding hearings on the possibility of tax reform and that you have a report on Federal tax subsidies. I would appreciate obtaining a copy of this report and the hearings.

Am enclosing a background paper which discusses the desirability of partially substituting an energy tax for the local property tax. Our Municipal Finance Study Group is now undertaking some studies to develop a plan for implementing such a tax.

I would be grateful if this background paper could be inserted into the record of your hearings. It seems clear that ways must be found to conserve energy in the decade ahead and that a properly designed energy tax could help to solve a variety of social problems.

Sincerely,

EDWARD F. RENSHAW, *Director,*
Municipal Finance Study Group.

ON A PARTIAL SUBSTITUTION OF AN ENERGY TAX FOR THE LOCAL PROPERTY TAX

(By Edward F. Renshaw)

If gasoline and other liquid hydrocarbons were subject to a special excise tax equal to ten cents per gallon, the United States would be able to raise about $23 million in extra revenue at present consumption rates, to improve public transportation, reduce the tax on local property, improve the equality of educational opportunity and solve a variety of other social problems. A comparable per unit tax on all forms of energy consumption would be sufficient to completely replace the local property tax which now yields about $45 billion in local revenues, more than half of which is used to support public schools.

A special tax on energy consumption would seem particularly desirable from a social point of view since it would help to reduce environmental pollution, improve our balance of payments position, lessen traffic congestion, conserve fossil fuels and give scientists and engineers more time to develop substitutes for exhaustible energy. The main objection to an energy tax is that it might tend to be regressive. This problem could be solved, however, by using the proceeds to benefit disadvantaged groups and to partially replace the local property tax, which also has repressive features. The need to seriously consider alternative tax structures has been heightened in recent years by a number of court decisions which have challenged the constitutionality of the local property tax as a fair and equitable source of financing for elementary and secondary education.

THE ENERGY CRISIS

The editors of *Business Week* have recently pointed out that the U.S. is becoming a have-not nation:

Gas shortages have already appeared in parts of the country, and production is expected to decline in the years ahead. Oil output is leveling off. It will be about the same in 1985 as it is today, according to industry projections. In the same period, U.S. energy will double.

The result, inescapably, will be a rising dependence on supplies of foreign oil. While nuclear power plants and increased coal output will fill part of the energy gap, the National Petroleum Council figures that oil imports will jump from 3.4 million bbl. a day in 1970 to nearly 15 million in 1985.

This shift toward dependence on foregin oil is occurring just at the time when the international oil business has switched from a buyers' to a sellers' market. And it will remain so, because worldwide energy demand is doubling every decade, creating an insatiable thirst for fuels. * * *

To avert a full-fledged energy crisis at some time in the future, the U.S. needs something it has never had: a national energy policy. * * *

The U.S. must consider for the first time how to limit its energy demands and allocate energy to the most essential uses. It must begin to think in terms of conserving its dwindling energy resources.[1]

The consumption of mineral fuels grew less rapidly than GNP between 1920 and 1965 but has since been increasing more rapidly than total output.[2] The work output of mineral fuel during the same period of time appears to have increased more rapidly than GNP. Summers has suggested that:

One can estimate very roughly that between 1900 and 1970 the efficiency with which fuels were consumed for all purposes increased by a factor of four. Without this increase the U.S. economy of 1971 would already by consuming energy at the rate projected for the year 2025 or thereabouts.[3]

It has become much more difficult to improve the efficiency of energy converting devices in recent years—the limits to technical efficiency are well understood in the case of heat engines and are rapidly being approached—and this may help to explain why the consumption of mineral fuels has been growing more rapidly than GNP since 1965.

In 1960 the energy staff at Resources For the Future suggested:

> Viewed strictly from the standpoint of its natural resource position and with due allowance for technological advance, the United States in 1975 or therabouts could satisfy its demand for all ènergy, and for each of the energy materials of which the total is composed, from domestic sources of supply at no significant increases in costs, except for those which might be brought about by a rise in the general price level.[4]

These conclusions now seem overly optimistic. Our reserves of natural gas, which have been supplying about a third of our energy requirement, have declined for several years and will probably be largely exhausted by the turn of the century.[5] Natural gas is a clean fuel from an environmental point of view. As the shortage spreads across the United States and cutbacks are ordered in large metropolitan areas [6] we are likely to observe a significant increase in air pollution.

Petroleum is another resource which could be largely exhausted before the turn of this century if past growth rates continue. Even more disturbing in some respects than the recent leveling off of domestic production in this country are reports that the reserves of Kuwait [7] and Canada [8] may have been exaggerated. Rising concern about air pollution is another factor which could help to create a shortage of liquid fuels in the near future.

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[1] *Business Week*, January 29, 1972, p. 80.
[2] Early Cook, "The Flow of Energy in an Industrial Society," *Scientific American*, September, 1971, p. 140.
[3] Claude M. Summers, "The Conversion of Energy," *ibid.*, p. 149.
[4] Sam H. Schurr, et al., *Energy in the American Economy*. Johns Hopkins Press, 1960, p. 4.
[5] John McKetta, Professor of Chemical Engineering at the University of Texas has told the House Committee on Interior and Insular Affairs that annual discoveries of natural gas in the United States will never again equal or exceed annual production throughout the rest of our lives. This could imply a continued decline in our natural gas reserves. See, Edward Cowan, "More Atom Power Is Backed by Lapp," *The New York Times*, April 13, 1972, p. 15.
[6] Dana Admans Schmidt, "Growing Deficit of Gas Forecast," *The New York Times*, February 26, 1972, p. 46: "Natural Gas Shortage Spreads Across U.S.," *Knickerbocker News*, March 10, 1972, p. 6C.
[7] "Kuwait's Reserves of Oil in Doubt," *The New York Times*, February 9, 1972, p. 51.
[8] Edward Cowan, "Arctic Oil Prospects Called Inflated," *The New York Times* November 26, 1971, p. 59.

No lead gasoline is consumed less efficiently than leaded gasoline and to obtain the same performance characteristics without lead, oil companies will have to consume more energy in the refining process.[9] Automobile makers are now considering the possibility of replacing reciprocating engines with a rotary-powered Wankel engine which produces fewer nitrogen oxides. A top GM executive has reported that early tests indicate that the Wankel is a poor starter in cold weather and that it currently consumes as much as 25% more fuel than a piston engine.[10]

While the United States is known to possess a large quantity of rock from which a liquid called "shale oil" can be extracted, only 30-40 billion barrels are currently considered recoverable at prices approaching the posted price of crude oil.[11] At projected rates of consumption for 1985, these supplies could be exhausted in less than four years.

Most of our shale oil reserves are located in arid parts of Western Colorado, Utah and Wyoming. Its exploitation will require technology which has never been developed beyond the pilot plant stage and substantial investments in reservoirs and aqueducts to provide processing water.

Diversion of water for this purpose will tend to increase the salinity of the Colorado River and impose external costs on farmers in Arizona and Mexico. Even more disturbing, in some respects, is the huge amount of fine dust particles that will be created as a by-product of grinding and heating the shale to remove the oil. Since the shale is located in a windy area, this could provide the substance for another American dust bowl and encourage environmentalists to employ legal strategems to impede the rapid development of shale oil.

The United States does have large reserves of coal. Most of the low sulfur coal reserves are also located in the far West, however, at great distances from existing population centers. While coal companies are planning to convert some of this coal into a substitute for natural gas, we really do not possess a very economical or efficient method of converting coal into liquid hydrocarbons.

With our heretofore abundant supplies of iron ore needing only to be lifted into the blast furnace. our large deposits of coal that have not yet been exploited, and our postwar vision of nuclear fission opening up an almost unlimited supply of new energy, it has been easy to minimize and even neglect the social cost of natural resource scarcity. It is increasingly clear, however, that:

> The promise of atomic energy is not the creation of the affluent society, but its preservation. Netting production costs from the retail price of electricity would, in many instances, still leave "free" atomic energy valued at several times the alternative cost of providing comfort heat from coal and fuel oil.[12]

Since the publication of the U.S. Atomic Energy Commission report to the President on *Civilian Nuclear Power* in 1962 it has been recognized that a large increase in the atomic efficiency of nuclear power stations will be required if uranium and thorium are to make a significant contribution to the supply of electric power. Inferred reserves of U_3O_8 in a currently competitive price range from $5 to $30 per pound are so small as to possibly be exhausted before the turn of the century if atomic efficiency remains in the vicinity of one or two per cent. Breeder reactors with a projected efficiency several times that of conventional reactors are now in development but are not expected to free man from the specter of severe natural resource scarcity for several decades.[13]

Conventional reactors after several billions of dollars of research effort and after more than 25 years of intensive development, are still a rather trivial source of electric power. A number of respected scientists, moreover, are increasingly concerned as to whether the emergency shutdown mechanisms that are now used in nuclear power reactors will work well enough to prevent a major catastrophe involving the possible deaths of thousands of persons in the event of a cooling system rupture.

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[9] It has been estimated that about 5.5 per cent more crude oil must be processed to obtain a lead free gasoline with the same performance characteristics as leaded gasoline; the loss is largely due to the extra energy consumed in the additional refining process. See, "The Economics of Manufacturing Unleaded Motor Gasoline," Report by Bonner and Moore Associates to the American Petroleum Institute, 1967.

[10] "GM Tunes Up the Wankel Engine," *Business Week*, February 26, 1972, p. 19.

[11] F. L. Hartley and C. S. Brinegar, "Oil and Bituminous Sand," *The Scientific Monthly*, June, 1957, p. 279; Sam Schurr, *op. cit.*, pp. 386-89.

[12] Edward F. Renshaw, "The Substitution of Inanimate Energy for Animal Power," *The Journal of Political Economy*, June, 1963, p. 290.

[13] J. C. Van Staveren and J. J. West, "The Development of Nuclear Energy in Relation to the Resources of Nuclear Materials," United Nations Third International Conference on Peaceful Uses of Atomic Energy, Vol. 12, pp. 21-25.

Even if there were no danger of a core melt down or nuclear explosion, in the case of the breeder reactors which will be necessary to overcome a scarcity of fissionable uranium, there would still be some serious problems of adjusting to an all nuclear economy. While it is quite feasible to imagine electric railroads, large ships powered by atomic reactors, small cars with speeds up to 35 miles an hour and ranges up to 40 miles which obtain their power from electric batteries, and even atomic powered space ships, no one has seriously proposed that atomic reactors be designed for small boats, large automobiles, mobile trucks capable of delivering heavy loads long distances, farm tractors, or commercial aircraft. The danger of accidents and contamination with radioactivity is simply too great.

The seriousness of natural resource scarcity can perhaps best be illustrated by comparing the caloric exchange ratios for petroleum and vegetable oil. Crude oil at $3.00 per barrel and vegetable oil at ten cents per pound have a caloric exchange ratio of about ten to one in favor of petroleum. Petroleum is scarce, however, and will eventually be used up. Oil production in such historically important states as Pennsylvania, California, Illinois, Indiana, Colorado, Kansas, Nebraska and Utah has already peaked out and is now in the process of absolute decline. As existing and yet to be discovered supplies of liquid hydrocarbons are used up, caloric prices will rise to equal and perhaps even exceed the price of vegetable oil, which is more perishable and not as good as a source of materials for plastics and some essential chemicals.

NEGATIVE SOCIAL WEALTH

Suppose we value the consumption of petroleum, not in terms of its historical cost of production, but in terms of its probable replacement cost. As a first approximation we shall use the price of vegetable oil, which has averaged more than ten times as much per calorie as petroleum, as our best estimate of replacement cost.[14a]

Figures provided in the RFF compendium, *Energy in the American Economy, 1850–1975*, indicate that the United States produced at least 304,982 trillion Btu equivalent of crude oil prior to 1956 and that the price of crude oil relative to the wholesale price index, though quite volatile was rather trendless from 1900–1955.[14b]

Starting with an average price per barrel of $2.77 in 1955 and assuming an eventual ten-fold increase in the relative price of crude petroleum we obtain a cumulative negative wealth value for crude petroleum produced in the United States through 1955 equal of $1,457 billion. This can be compared to Goldsmith's estimate of $1,270 for reproducible tangible wealth in 1957 and Schultz's estimate of $848 billion for educational capital investment in the U.S. population.[15]

While educational capital has increased more rapidly than petroleum consumption since 1957, owing in large part to the postwar baby boom and the trend toward relatively more higher education, it is rather doubtful whether reproducible tangible wealth has grown as rapidly as the negative social wealth associated with petroleum consumption.[16] It should be emphasized that crude oil

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[14a] In *Science and Economic Development*, which was first published in 1956, Richard Meier noted that "converting electricity into liquid fuels, for example, is a particularly poor transformation," and suggested that algal culture might turn out to be the least expensive source of liquid fuels once fossil fuels are used up. He guessed that in some locations liquid fuels might be produced for as little as $150 per ton which would still be almost ten times the 1955 price for crude oil at $2.77 per barrel. It should be emphasized that our current consumption of liquid hydrocarbons is many times greater than our net agricultural product and that the amount of land and water that is suitable for algal culture and can be freed from food production is likely to be small.

The most promising substitute for large scale mobile transport is liquid hydrogen which could be obtained from the electrolosis of water using atomic energy. Hydrogen is a bulky commodity, even in a liquid state and is also a rather inconvenient and dangerous material to produce, distribute and utilize in small quantities. For some thoughts on this subject see, Lawrence W. Jones, "Liquid Hydrogen as a Fuel for the Future," *Science*, October 22, 1971, pp. 367–70.

[14b] Sam H. Schurr and Bruce C. Netschert, *Energy in the American Economy*. Baltimore: Johns Hopkins Press, 1960, pp. 495–547.

[15] Theodore W. Schultz, *The Economic Value of Education*. New York: Columbia University Press, 1963, p. 51.

[16] Wealth estimates are not available for recent years. Our production and consumption of crude petroleum, however, grew more rapidly between 1955–70 than gross private domestic investment in constant prices. Capital consumption allowances were quite small in the early post World War II period and since 1955 have increased more rapidly than gross private domestic investment.

has supplied considerably less than half of our energy requirements. If an allowance were made for the probable future price increases for coal, natural gas, and other scarce mineral resources, the implication would seem to be that the United States has been growing poorer, instead of richer. Monetary incomes are, of course, much higher than was formerly the case, but only at the expense of a rapid deterioration of our stock of mineral wealth. In 1915 Wilford King, one of the foremost pioneers in natural income accounting, noted:

It is a commonplace that the United States has been endowed with great mineral resources and that these gifts of nature have been rapidly "developed" or "exploited." Useful minerals are the product of long ages of geologic activity and, in the historical life of the nation, the amount of deposits formed has been negligible. When we rapidly "develop" our mines or oil wells, we are in the position of the spendthrift who inherits a fortune with the provision that it is to be paid to him in annual installments, but who, by some hook or crook, arranges to double the size of each installment. As a result, he lives, at present, in great affluence, but, when his estate is once squandered, he will be in poverty. Likewise, it is true of our mining operations that every ton of coal, every barrel of oil removed from the earth means an irremedial loss to our national estate. Each year, our social wealth, as represented by minerals, grows less and less and the more flourishing the condition of our mining industry, the more rapid the disappearance of our mineral estate.[17]

With respect to our consumption of petroleum King noted:

At best, this variety of our natural resources is being depleted with great rapidity and seems destined, ere many decades, to practically disappear. Yet, despite countless warnings, we still recklessly squander this priceless heritage for uses in which a barrel possesses but relatively slight utility. We construct great locomotives and ships to burn it in ever increasing quantities even though its superiority over coal is but slight and the fraction of its total energy utilized is but trivial; we even sprinkle it over our streets and highways, all regardless of the fact that, in so doing, we are dissipating the material needed to light the lamps of the poor and propel the aeroplanes of the rich only a generation or two hence.[18]

While atomic energy may have lessened our dependence on oil to light the lamps of the poor, the over-all impact of new technology seems to have been that of making our society ever more dependent upon one of our most exhaustible resources. In 1915 when King's words were first written, crude petroleum supplied less than ten per cent of our total energy requirements. Production has since risen to about a third of total energy consumption. Reverting back to an economy which utilizes only small amounts of liquid hydrocarbons may not be a simple matter, since much of our residential, commercial and industrial capital is now dispersed in a manner that does not lend itself to economical electrification as far as heating and transportation are concerned.

In view of the rapidity with which petroleum and other fossil fuels might be exhausted if consumption continues to increase at an exponential rate,[19] the very large price increases that are almost certain to accompany scarcity, and the lack of a perfect substitute in many important uses, a case can be made to the effect that fossil fuels are currently underpriced and ought, therefore, to be taxed[20] in order to prevent wasteful consumption and to discourage the premature development of submarginal mines and reservoirs.

THE CONSERVATION OF ENERGY

In this dilemma, there needs to be much more serious discussion of alternatives for retarding the growth of energy demand, and even of reducing it. In general, power and fuel prices do not reflect the costs of environmental damage. A

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[17] Wilford I. King, *The Wealth and Income of the People of the United States.* New York: The MacMillan Company, 1922, pp. 33–34.

[18] *Ibid.*, p. 38.

[19] The epitome of our "use-it-up" psychology is a recent TV ad by a leading oil company suggesting that Alaska's North Slope discovery may only provide us with a three year supply of petroleum.

[20] The use-tax method is the classical economic solution to the problem of both increasing cost industries and a divergence between social and private costs. See A. C. Pigou, *The Economics of Welfare.* London: MacMillan Company, 1932, p. 192. See also, Edward F. Renshaw, "The Substitution of Inanimate Energy for Animal Power," *The Journal of Political Economy,* June, 1963, pp. 284–92; S. David Freeman, "Toward a Policy of Energy Conservation," *Bulletin of the Atomic Scientists,* October, 1971, pp. 8–12.

substantial additional tax on all fuel and power could discourage frivolous energy consumption and provide funds for environmental reconstruction.

Alternatively, the possibility has to be faced that eventually fuel and power may have to be rationed, perhaps by setting an upper limit per person on family electricity consumption. Or commercial and public buildings might be rationed on air conditioning. None of these or similar steps to reduce energy demand is attractive nor is a Presidential election year the ideal time to expect politicians to discuss such a touchy issue candidly.

But sooner or later the problem will have to be faced, and how well it is handled will depend on the extent of earlier debate. The first limit on growth, it is now evident, will be the energy limit; and if it is a meteorologically hot summer this year New Yorkers and others will discover how close those limits are right now.[21]

Steps have already been taken to help conserve our dwindling supplies of natural gas and heating oil by setting new standards for insulation in federally insured houses. The new standards applicable to single family structures require insulation to reduce maximum permissible heat loss by about one-third for a typical home; the fuel savings each year are expected to equal the cost of the additional required insulation. The Secretary of Housing and Urban Development is now revising standards applicable to federally insured apartments and other multi-family structures. These standards will reduce maximum permissible heat loss by about 40% and are expected to save enough fuel to pay for the extra insulation over a five year period.[22]

The problem with these standards is that they apply only to houses and apartments which are insured by the Federal government. An energy tax would encourage all owners of homes and heated apartments to install insulation.

While an important change in public attitude would be required, there is really no necessity for the United States to become increasingly dependent upon foreign oil. By reducing the average size of the American automobile from 4,000 pounds to the one ton compact car that is common in most oil poor industrial nations and by making sizable investments to improve public transportation, which uses less than a third as much petroleum per passenger mile as the American automobile, we could easily solve the current energy crisis without great inconvenience to American consumers.

A rapid transition to smaller automobiles would have an added advantage in enabling Detroit to satisfy the 1975 air quality standards without a large investment in engine modification and new emission devices. Emission standards for hydrocarbons were originally expressed in terms of parts per million of the pollutant in the exhaust. In recognition of the fact that it is the quantity of pollutants emitted to the air rather than the concentration in the exhaust that determines over-all pollution levels, the Federal government has switched to a measurement of automobile pollution in grams per mile beginning with 1970 standards. Since small cars use less fuel it will be easier for them to meet the air quality standards for 1975. The trend toward smaller cars has, of course, been underway for more than a decade.

In a recent issue of *Motor Trend* it was noted that 100 percent of all car sales in the United States could be classified as large automobiles in 1951. Only 45 percent of total sales were large automobiles in 1971, 35 percent were intermediate and 20 percent small cars. Chris Packard, the author, predicts that large cars will no longer be produced by the year 2,000, that the market share for intermediate sized cars will have declined to 10 percent, that small cars will have captured 40 percent of the market and that the remainder of the market will consist of mini and sub-mini cars.

The demise of the large car no longer in existence after 1980 boils down to money and logistics. The intermediate can do the same job as the large car with a lower initial price, smaller package and a smaller, more economical engine, using fewer pounds of materials in the process. If buyers don't put the large cars out of business through lack of interest or the manufacturers don't withdraw them from the marketplace, the government may step in and rule them off the road despite what Mr. Haddon and the Insurance Institute for Highway Safety say. We can't afford the large car's consumption of energy and materials when it is not returning utility equal to its appetite. If it doesn't get more efficient, the same fate may face the intermediate a few years later.[23]

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[21] "Energy Crisis Ahead," *The New York Times*, April 10, 1972, p. 32.
[22] *Joint Economic Report*, 1972, p. 107.
[23] Chris Packard, "The Future of the Automobile in America," *Motor Trend*, April, 1972, pp. 86 and 90.

Packard concludes:

> There will be cars in the future, although they'll be different than the cars most Americans are used to buying. Efficiency of packaging and small size will be the outstanding characteristics of future cars, but this does not mean the option list is dead nor does it mean Americans will suddenly start spending less money for their cars. It does mean that Americans are discovering, and will continue to discover, the smaller car has nearly the same usable interior space, almost as much usable luggage space, the same legal cruising speed, easier and cheaper maintenance, and will go further on a dollar's worth of gas than a larger car. As Americans become increasingly interested in sailing, hiking, growing plants, riding bicycles and motorcycles, and become less interested in impressing their neighbors with fat cars that clog up the highways and won't fit into garages or parking spaces, they'll buy more small cars.[24]

A tax on energy would not only tend to accelerate the trend toward smaller and more efficient automobiles but would also have the advantage of encouraging individuals to car pool and to utilize public transportation. Some statistics compiled by Richard Rice suggest that buses and passenger trains are from three to four times as efficient in moving passengers as the private automobile and that the automobile, in turn, is about half again as efficient at moving passengers as a large jet aircraft flying below the speed of sound.[25]

It practically goes without saying that a comprehensive energy tax would also encourage people to walk, ride bicycles, use less air conditioning, turn out electric lights when not in use and in other ways strive to economize in the use of commodities and gadgets which consume energy.

The proportion of GNP going into the production of basic energy has averaged a little less than three per cent in the years since 1900. If this energy were valued at its probable replacement cost, however, and if GNP were depreciated to reflect natural resource exhaustion and expenditures that will be necessary to offset the deleterious side effects of pollution it is not unreasonable to suppose that real GNP would be from one-third to one-half less than current estimates. In the words of Paul Samuelson, " * * * most of us are poorer than we realize. Hidden costs are accruing all the time; and because we tend to ignore them, we overstate our incomes." [26]

More important, perhaps, than the direct impact of a tax on energy resources is the revolution in public attitude which might result from a national effort to encourage people to conserve exhaustible energy. Consider for a moment the words of Henry David Thoreau:

> Most of the luxuries, and many of the so-called comforts of life are not only not indispensable, but positive hindrances to the elevation of mankind. * * *
>
> Our inventions are wont to be pretty toys, which distract our attention from serious things. They are but improved means to an unimproved end, an end which it was already but too easy to arrive at; as railroads lead to Boston or New York. We are in great haste to construct a magnetic telegraph from Maine to Texas; but Maine and Texas, it may be, have nothing important to communicate. * * *
>
> One says to me, "I wonder that you do not lay up money; you love to travel; you might take the cars and go to Fitchburg today and see the country." But I am wiser than that. I have learned that the swiftest traveler is he that goes afoot. I say to my friend, Suppose we try who will get there first. The distance is thirty miles; the fare ninety cents. That is almost a day's wages. * * * I start now on foot, and get there before night. You will in the meanwhile have earned your fare, and arrive there sometime to-morrow, or possibly this evening, if you are lucky enough to get a job in season. Instead of going to Fitchburg, you will be working here the greater part of the day. And so, if the railroad reached around the world, I think that I should keep ahead of you. * * *

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[24] *Ibid.*, p. 122.

[25] Rice also estimates that a supersonic aircraft would require almost twice as much fuel per passenger mile as a subsonic jet of comparable size. The propulsion efficiency of the SST is so low as to put it in a class with superliners, helicopters, and pullman night trains—innovations that have either ceased to be economic or have never been very successful from an economic point of view. See Richard Rice, "System Energy as a Factor in Considering Future Transportation." A paper presented at the ASME Winter Meeting, November 29, 1970, New York City.

[26] *Newsweek,* October 6, 1969.

Such is the universal law, which no man can ever outwit, and with regard to the railroad even we may say it is as broad as it is long. To make a railroad round the world availab.e to all mankind is equivalent to grading the whole surface of the planet. Men have an indistinct notion that if they keep up this activity of joint stocks and spades long enough all will at length ride somewhere, in next to no time, and for nothing; but though a crowd rushes to the depot, and the conductor shouts, "All aboard!" when the smoke is blown away and the vapor condensed, it will be perceived that a few are riding, but the rest are run over.[27]

INTERNATIONAL IMPLICATIONS OF A TAX ON ENERGY

Growth is as deeply entrenched in our economic thinking as rain dancing has been for some other societies. In each case there is faith that results will come indirectly if a capricious and little-understood power is propitiated. Thus, instead of concentrating directly on the goods and values we want, we emphasize growth, exploit the environment faster, and assume that good things will follow by some indirect mechanism.

From time to time, the correlation between rainfall and rain dancing must have been good enough to perpetuate the tradition. Similarly, the correlations between exploitation of the environment, growth, and progress were usually excellent in our recent past. So great have been the successes of our economic habits that they have become almost sacrosanct and are not to be challenged.

However, here in the United States as in most of the world, the relationships between people and environment have changed drastically, and past experience is no longer a reliable guide. While we rush headlong through the present with frontier-day attitudes, our runaway growth generates noxious physical and sociological by-products that threaten the very quality of our lives. Although we still seem confident that technology will solve all problems as they arise, the problems are already far ahead of us, and many are growing faster than their solutions.[28]

In March of 1972, the Texas Railroad Commission, for the first time since 1948, increased allowable oil production from wells in our largest producing state to 100 per cent of their "maximum efficient" rate for April, 1972. The action came after executives from the nation's largest oil companies said that domestic production simply could not meet more than a fourth of the 800,000 to 900,000 extra barrels a day that our nation is expected to use in 1972.[29]

From 1965 to 1970 the United States enjoyed a fairly stable trade surplus of about $9.0 billion in high technology products.[30] That surplus—which was necessary to finance foreign aid, our Vietnam involvement and a growing deficit in international travel, low technology products, and raw materials—has since declined in a fairly dramatic manner. (Further erosion can be expected in the future as the United States begins to lose its postwar monopoly in large, commercial jet aircraft.)

A smaller surplus of high technology exports caused the United States to suffer an over-all deficit in its international trade balance in 1971, for the first time in more than 100 years. Assuming that there is no improvement in the months ahead we could wind up 1972 with a total trade deficit in the vicinity of $6 billion. A significant part of this deficit is the result of increased oil imports.

If imports were allowed to reach the more than 14 million barrel a day figure that has been projected by the National Petroleum Council for 1985, the impact on our balance of payments could easily be in the neighborhood of from $20 to $25 billion per year—a sum so large as to not seem realistic in view of our present and prospective balance of payments problems.

A large tax on the consumption of petroleum products would be particularly attractive from a balance of payments point of view since most of the decline in consumption would be at the expense of foreign imports rather than domestic production. It has been estimated that at least 75 per cent of the oil to be found in the 48 contiguous states and the adjacent continental shelves of the United States has already been discovered and that higher price and new discoveries

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[27] Henry David Thoreau on economy from *Walden*. Reprinted in *Economic Growth vs. the Environment*, edited by Johnson & Hardesty. Wadsworth, 1971, pp. 186–87.

[28] J. Alan Wagar, "Growth Versus the Quality of Life," *Science*, June 5, 1970, p. 1180.

[29] "Texas Oil Rate at 100% for First Time Since '48," *The New York Times*, March 17, 1972, p. 59.

[30] "Maurice H. Stans Sees Technology as Likely Key to Balancing U.S. Trade," *The Weekly Bond Buyer*, August 30, 1971, p. 11.

in Alaska are not likely to be sufficient to prevent a peaking out of total production in this country in the next few years.[31] With most of our own oil already discovered we will either have to cut back the growth in consumption or increase imports until economical and environmentally sound methods of extracting liquid hydrocarbons from coal and shale oil have been developed.

Another advantage of a tax on petroleum products is that it would increase the size of the small car market, lengthen assembly runs and make it more necessary and economical for U.S. auto-makers to vigorously compete for this market. One of the most encouraging aspects to our balance of payments picture in the first half of 1972 is evidence which suggests that the production of small domestic cars can make an inroad on foreign car sales. If consumers were faced with an even wider range of domestically produced small cars, U.S. auto-makers might be able to again bring the dollar value of automobile exports into line with imports.

A chronic deficit in our balance of payments is not the only factor that should be considered in formulating a national energy policy. Even more worrisome in some respects is the foreign policy implications of becoming over 50 per cent dependent upon foreign oil as is the case with many of our closest allies. John McLean, President of Continental Oil Company has suggested:

> We should lift our concern with energy matters from the national to the international level. We should develop programs and policies that deal not only with the United States energy problems but also with similar problems confronting other consuming countries.
>
> Free World dependence on oil imports in 1985 will be highly concentrated. Of all Free World oil reserves outside the United States and Canada, 86 per cent are situated in the 11, predominantly Arab, members of the Organization of Petroleum Exporting Countries. Massive tax increases exacted by these countries on oil operations in 1971 provide ample evidence that they recognize their position and are prepared to use it aggressively.[32]

It practically goes without saying that a slower growth in oil imports from the middle east would strengthen our international bargaining position and allow us to pursue a more neutral policy with regard to the touchy Arab-Israeli conflict. Oil poor Western Europe and those underdeveloped countries without adequate petroleum resources would also benefit from not having to compete so vigorously with the United States for middle east oil. And while the revenues of oil exporting nations would clearly be less in the short run, there is a possibility that the citizens of these countries might be better off in the long run by having their most important natural resource produced and distributed over a longer period of time.

While high rates of energy consumption may help to facilitate rapid economic growth in the short run, they do not necessarily provide any assurance that social wealth is increasing or that the higher levels of income and private wealth stocks in such forms as automobiles, jet aircraft, super highways and petroleum refineries—investments which have depended upon a cheap supply of liquid hydrocarbons—can be maintained in the future.[33] Consider for a moment, Samuel Ordway's theory of progress:

> Premises: Levels of human living are constantly rising with mounting use of natural resources. Despite technological progress, we are spending each year more resource capital than is created.
>
> Theory: If this cycle continues long enough, basic resources will come into such short supply that rising costs will make their use in additional production unprofitable, industrial expansion will cease, and we shall have reached the limit of growth.
>
> Conclusion: If this limit is reached unexpectedly, irreparable injury will have been done to the social order.[34]

Ordway's theory of economic progress has recently been revived in a report by the Club of Rome on *The Limits of Growth.* While this report is still controversial, there is not much doubt that the nited States has been consuming more than its share of the world's petroleum resources and that differences in

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[31] M. King Hubbert, "The Energy Resources of the Earth," *Scientific American,* September, 1971, p. 65.

[32] *Electric Vehicle News,* February, 1972, p. 24.

[33] It is quite clear from a glance at *Fortune*'s list of the 500 largest industrial companies that the assets which are used to extract, refine and distribute petroleum dominate our industrial wealth.

[34] Samuel H. Ordway, *Resources and the American Dream.* Ronald Press, 1953, pp. 31–32.

consumption levels are at least partly related to taxes. The United States, with about 1/20th of the world's population has until recently been consuming about 1/3rd of the world's petroleum resources.

In Western Europe and many developing nations it is not uncommon to collect an excise tax of 50 cents or more per gallon of gasoline. Federal and state gasoline taxes averaged only 10.86 cents in 1970 and virtually all of the proceeds were used to provide complementary highway services. When natural resource scarcity is viewed from an international perspective, it is quite clear that the United States has not been doing its part to conserve fossil fuels.

MAKING AN ENERGY TAX MORE PROGRESSIVE

The main objection to an energy tax is the possibility that it might prove regressive in the short run. In a longer run context all income groups should be better off economically by virtue of cheaper and more abundant supplies of fossil fuel energy than would otherwise be the case. While the problem of regressivity could be partly solved in the case of electricity and natural gas by charging rates which increase with the amount of energy consumed per household, rather than decrease as consumption increases, there would still be inequities resulting from the fact that poor people usually cannot afford to buy new homes and may be forced to live in older housing which was designed for a more affluent level of energy consumption.

In the case of automobiles there would be an even more difficult problem in developing a progressive excise tax on energy consumption since consumers are free to purchase gasoline at many different locations. An alternative way of making an excise tax on energy more progressive would be to levy a flat rate but use the proceeds for public transportation and other worthwhile purposes that provide disproportionate benefits to families and individuals with low and moderate incomes.

Diversion of motor fuel, motor vehicle, and motor carrier taxes to non highway purposes has, on an historical basis, been rather limited. In 1964 only 9.44% of state highway-user tax receipts were diverted to other purposes; in 1969 the diversion amounted to 8.82 percent, a relative decrease.[35] The idea that excise taxes on motor fuels should be used to help solve other problems, such as improved public transportation, does seem to be gaining political favor, however, The Virginia State Highway Commission has recently agreed to allocate $35 million over the next 10 years for mass transit facilities in five northern Virginia jurisdictions. This marks the first time that the commission has earmarked highway funds for such use.[36]

An expansion of the Federal Highway Trust Fund to encompass grants for mass transit as well as new highways has been a lively political issue for quite some time.[37] In 1971 the California legislature voted to extend a five per-cent sales tax to gasoline for the primary purpose of aiding both rural highways and urban mass transit.[38] It has even been reported that U.S. auto-makers are now beginning to back the idea of a gas tax for mass transit.[39] Since about 75 per cent of our mass transit needs will be met by buses which need good roads and also have the advantage of reducing automobile congestion, there is really more complementarity between these two transportation modes than is sometimes supposed.

While one would hope that the Federal Highway Trust Fund will eventually be used to aid mass transit, it is questionable whether this would reduce the growth of energy consumption significantly. Road builders and highway users are still a powerful political force. It is doubtful whether they would agree to divert funds from the Highway Trust Fund to public transportation without some assurance that the amount of money spent on new highways will also be greater than would otherwise be the case. Better roads and significantly faster mass transit are, in the final analyses, so complemetary with increased energy utilization as to possibly cause people to commute longer distances and consume

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[35] American Petroleum Institute, *Petroleum Facts & Figures: 1971 Edition*, p. 490.
[36] "Va. Highway Commission Sets First Allocation for Mass Transit Facilities," *The Daily Bond Buyer*, July 11, 1972, p. 28.
[37] For an interesting review of political efforts in behalf of a General Transportation Trust Fund, see, "Ecologists Attack the Highway Trust Fund," *Business Week*, December 11, 1971, p. 86.
[38] *The Daily Bond Buyer*, August 12, 1971, p. 23 and July 6, 1972, p. 23.
[39] Agis Salpukas, "Auto Makers Back Gas Tax for Transit," *The New York Times*, January 26, 1972, p. 61.

more energy, rather than conserve our vanishing petroleum resources. To be confident that an energy tax will reduce consumption, society might have to use the proceeds for other purposes besides the provision of better transportation.

One purpose which could help to make a tax on energy—including natural gas and heating oil—more progressive, would be to use part of the proceeds to institute a housing allowance for all families with low and moderate incomes. While an increasing number of housing authorities have suggested that a housing allowance, which allowed families to shop around for both new and old housing would provide better housing for the poor at less cost to the Federal Government,[40] it is not certain whether one could muster enough political support for an energy tax which only benefited families with low and moderate incomes.

A more intriguing purpose, from a political point of view, would be to earmark most of the proceeds for elementary and secondary education in a manner that can be expected to bring about a substantial reduction in local property taxes. A recent survey by the Advisory Commission on Intergovernmental Relations indicate that "Americans have strong—and negative—feelings about their local property tax, considering it the least fair of the major tax sources." [41] In its analysis of the opinon survey the ACIR noted that regardless of age, income, area of residence, type of employment, race and other such factors each group of taxpayers surveyed "decisively voted the property tax as being the least fair—and generally by margins of 2-to-1." [42] The survey also indicated that the public would prefer an increase in the sales tax if states should be forced to raise large amounts of new tax dollars.

Colorado voters will apparently be given an opportunity to vote on a constitutional amendment this November limiting the annual ad valorem tax on real property to not more than 1.5% of its actual value. The proposed amendment would allocate 5% of the 1.5% to the state, 20% to local school districts and 75% to counties and local government units.[43] James McGrew has noted:

> Today the property tax seems to have more, and more powerful, enemies than ever before. No longer is the opposition confined to college professors, governmental researchers and others of those who used to be called "long-hair types." Now the property tax numbers among its enemies a short-haired President of the United States and numerous short-, medium- and long-haired candidates for his job. Ralph Nader has decided that the property tax is on a par with the Corvair, the Volkswagen, artificial sweetners and the other demons that inhabit the Inferno in which the hapless consumer dwells.
>
> Now, even the cartoonists are picking on the poor old property tax. In one, a matronly type inspects get well cards and asks the salesman "What do you suggest for someone who's just had his property reassessed?"
>
> And in a Jim Berry cartoon, a sick looking customer asks the pharmacist: "Do you have anything I can take for property taxes?" [44]

While states and even local governments could impose special taxes on energy for the purpose of relieving local property taxes, it would seem fairer and more efficient to have the Federal government impose a set of excise taxes on various energy sources and redistribute the proceeds back to states in proportion to estimated energy consumption. This would help to prevent energy producing areas, manufacturing regions, and states which serve as transportation corridors from exploiting energy demands which originate in other states.

It would have the further advantage of discouraging motorists in border towns from engaging in counter productive travel to neighbornig states to obtain fuel at a lower tax. The problem of conserving energy, in the final analysis, is a

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[40] The housing allowance alternative has been given considerable attention in an excellent set of papers which were submitted to the Subcommittee on Housing Panels of the Committee on Banking and Currency, House of Representatives in June, 1971, and in *Setting National Priorities: The 1972 Budget*, by Charles L. Schultze and other analysts at the Brookings Institution. It was also a focal point for discussion at a highly successful conference on housing the poor sponsored by the Municipal Finance Study Group at the State University of New York at Albany on August 6, 1971. Professor Donald Reeb and James Kirk have been editing the various papers and taped discussions by 17 housing economists and administrators from around the U.S. and from Canada for publication by Praeger toward the end of 1972.

[41] John Gerrity, "To End Property Tax: ACIR May Favor VAT with Rise in State Levy," *The Daily Bond Buyer*, July 6, 1972, p. 1.

[42] *Ibid.*, p. 24.

[43] "Colorado Will Vote in November on Plan to Limit Property Taxes," *The Daily Bond Buyer*, July 11, 1972, p. 1.

[44] "Significance of Recent School Cases on the Future of the Property Tax," *The Daily Bond Buyer*, June 23, 1972, p. 16.

national problem and not a burden that should be shouldered in a disproportionate manner by persons in those states that are most in need of additional revenue.

An allocation of a Federal energy tax to the various states in proportion to energy consumption would also be a fairly simple way to prevent income transfers from predominantly rural states, which may be forced to consume more energy per capita, to urbanized states which may be more affluent. It practically goes without saying that a perverse redistribution of tax revenues from low income rural states to densely populated areas might seriously jeopardize the political feasibility of implementing a national tax on energy consumption.

The objections of farmers and low-income rural residents to an energy tax could be further reduced by earmarking the proceeds for education and by requiring the various states to adopt aid formulas which strive to equalize local tax burdens by adjusting for differences in personal income as well as differences in property values. Farm real estate values have arisen much more rapidly in the postward period than farm income. In 1945 the value of farm real estate was only 4.4 times as great as net farm income. By 1958 the capitalization ratio for farm real estate had risen to 8.6 and by 1971 to 13.1; the latter figure is almost three times the capitalization ratio which existed in 1945.

The upward surge in farm real estate values in the last decade and a half is in large measure the result of speculative forces and demands for land for recreational and retirement purposes which have originated outside of agriculture. Recognizing that these forces can create an income squeeze that may force farmers off the land, reduce rural GNP, and add to welfare burdens in congested cities, a number of state legislatures have passed agricultural districting laws which allow farm land to be assessed for tax purposes at preferentially low rates compared to the actual market value. A partial shift of state-aid equalization formulas from a property to an income base would tend to accomplish the same objective without the stigma of assessing and taxing some kinds of property differently.

Another way to make a tax on energy more progressive would be to require communities to develop "circuit breakers" or establish a system of property tax rebates for individuals and families with low and moderate incomes. The tax credit approach to making the property tax less regressive is currently used with some variation in at least ten states.[45] In Oregon a new law permits the deduction of property taxes from the state personal income tax liability when the property tax on the house or apartment reaches a certain percentage of income. A provision analogous to a negative income tax provision awards a payment to the taxpayer when the income tax is not high enough to accommodate the property tax.[46]

While more research must be undertaken to determine the net impact of an energy tax on income distributions, there doesn't appear to be any reason why the proceeds couldn't be distributed in a manner that will improve the fairness and equity of our tax and expenditure system as a whole. In 1857 John Stuart Mill noted:

> It must have been seen, more or less distinctly by political economists, that the increase in wealth is not boundless: That the end of what they term the progressive state lies the stationary state, that all progress in wealth is but a postponement of this, and that each step in advance is an approach to it.

Speaking before the Institute on Man and Science in 1970, Dr. Rene Dubos gave voice to a growing number of scientists and humanists who feel that the times may have caught up with John Stuart Mill:

> The ecological constraints upon population and technological growth will inevitably lead to social and economic systems different from the ones in which we live today. * * * Whether we want it or not, the phase of quantitative growth which has prevailed throughout technical civilization during the 19th and 20th centuries will soon come to an end.

Economic growth that is based upon increasing consumption of fossil fuel energy is one dimension of economic progress that must soon come to an end. While a peaking out and decline in the use of non renewable energy will no doubt cause some inconvenience, it does not necessarily follow that mankind will necessarily be worse off economically. For a slower growth rate for some kinds of

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[45] *Report of the New York State Commission on Quality, Cost and Financing* of Elementary and Secondary Education, January, 1972, p. 236.

[46] Richard W. Lindholm, "Twenty-one Land Value Taxation Questions and Answers," *American Journal of Economics and Sociology*, April, 1972, p. 155.

energy consumption might well open up a promising new era with more time for self realization, social interaction, and personal fulfillment.

John Stuart Mill has noted:

> I cannot * * * regard the stationary state of capital and wealth with the unaffected aversion so generally manifested towards it by political economists of the old school. I am inclined to believe that it would be, on the whole, a very considerable improvement on our present condition. I confess I am not charmed with the ideal of life held out by those who think that the normal state of human beings is that of struggling to get on; that the trampling, crushing, elbowing, and treading on each other's heels which forms the existing type of social life, are the most desirable lot of human kind.
>
> I know not why it should be a matter of congratulation that persons who are already richer than anyone needs to be, should have doubled their means of consuming things which give little or no pleasure except as representative of wealth * * *. It is only in the backward countries of the world that increased production is still an important object; in those most advanced, what is economically needed is a better distribution, of which one indispensable means is a stricter restraint on population * * *. If the earth must lose that great portion of its pleasantness which it owes to things that the unlimited increase of wealth and population would extirpate from it, for the mere purpose of enabling it to support a larger, but not a happier or better population, I sincerely hope, for the sake of posterity, that they will be content to be stationary, long before necessity compels them to it.
>
> It is scarcely necessary to remark that a stationary condition of capital and population implies no stationary state of human improvement. There would be as much scope as ever for all kinds of mental culture, and moral and social progress; as much and much more likelihood of it being improved, when minds cease to be engrossed by the art of getting on. Even the industrial arts might be as earnestly and as successfully cultivated, with this sole difference, that in serving no purpose but the increase of wealth, industrial improvements would produce their legitimate effect, that of abridging labor.

In a recent review of Jay Forrester's *World Dynamics*, William Bowen, President of Princeton University, has expressed similar thoughts:

> An end to growth in material output, moreover, would not necessarily be incompatible with economic growth of kinds not well measured by our present stock of indicators, notably growth in the quality of goods and services. With a renaissance of craftsmanship, of pride in work, of willingness to serve, a society poorer than ours by some statistical measures could enjoy goods or greater durability and higher aesthetic quality, and services performed with more courtesy, cheerfulness, and competence. And stability in material growth, finally, would not necessarily be incompatible with individual excellence, with devotion to one's craft, with love for one's children, with high achievement in the arts, with eloquence, with precise thought or careful expression, with enhanced sense of community, with deepened religious faith, or with care for the scarred yet still nurturing earth itself.[47]

NATIONAL FOREIGN TRADE COUNCIL, INC.,
New York, N.Y., July 17, 1972.

Mr. JOHN R. STARK,
Executive Director, Joint Economic Committee, New Senate Office Building, Washington, D.C.

DEAR MR. STARK: In connection with the forthcoming hearings of the Joint Economic Committee on tax reform, I enclose a copy of a letter which Mr. Robert M. Norris, the Council president, sent to Senator Proxmire enclosing a copy of a recent Council study entitled "*Economic Implications of Proposed Changes in the Taxation of U.S. Investments Abroad*".

I also enclose a copy of the latter for your information and use.

Yours sincerely,

MALCOLM ANDRESEN.
Director, Tax-Legal Division.

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[47] William Bowen, in a review of Jay Forrester's *World Dynamics, Fortune.*

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NATIONAL FOREIGN TRADE COUNCIL, INC.,
New York, N.Y., July 17, 1972.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee, New Senate Office Building, Washington, D.C.

DEAR SENATOR PROXMIRE: We are greatly interested in the hearings on tax reform that your Committee has scheduled to commence this week. We are also deeply interested in the paper on "*Tax Preferences to Foreign Investment*" by Prof. Peggy Musgrave, released by your Committee on June 11th.

Through our NFTC Tax Committee we shall be analyzing thoroughly Prof. Musgrave's paper with a view to responding to the points made in that document. In my view, the membership of our Council will hold that the analysis and conclusions of Prof. Musgrave are not supportable. My belief is based upon a document recently published by our Council entitled "*Economic Implications of Proposed Changes in the Taxation of U.S. Investments Abroad*". You have already received a copy of this document in our normal distribution of it to all members of the Congress as well as to other segments of our government.

Believing that our document is responsive to the Musgrave paper and, particularly germane to the forthcoming hearings of your Committee, I am enclosing ten copies of the study for use by the Committee with the request that a copy of the document be incorporated in and made part of the record of your hearings.

Sincerely yours,

ROBERT M. NORRIS,
President.

ECONOMIC IMPLICATIONS OF PROPOSED CHANGES IN THE TAXATION OF U.S. INVESTMENTS ABROAD

NATIONAL FOREIGN TRADE COUNCIL, INC.
10 Rockefeller Plaza, New York 10020

E R R A T A

Corrigendum - Page 21, second paragraph:

"refer to the table on page 12" (not Table A)

Corrigendum - Page 25, fourth paragraph:

"Thus, structural employment" (not structured)

ECONOMIC IMPLICATIONS OF PROPOSED CHANGES IN THE TAXATION OF U.S. INVESTMENTS ABROAD

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FOREWORD

This report is designed to supplement and update a previous study by the National Foreign Trade Council, published in November, 1971, on "The Impact of U.S. Foreign Direct Investment on U.S. Employment and Trade."

Studies issued subsequently by a number of other business organizations as well as by Government, academic institutions, and individual businesses also provide important sources for the conclusions presented herein.

In view of the continuing campaign by certain labor groups and others against U.S. private foreign investment, and the proliferation of proposals to restrict the international operations of U.S. business, exemplified particularly by the proposed tax provisions of the Burke-Hartke bill, we are giving wide circulation to this paper as a further contribution to public understanding of a complex subject.

ROBERT M. NORRIS
President

June, 1972

INTRODUCTION

"The Foreign Trade and Investment Act of 1972...is designed to put our domestic industry on an even footing with foreign competition and make domestic investment just as attractive as investment abroad... Profits earned by a foreign subsidiary of an American firm are not taxed until they are repatriated. To the extent that the firm does pay taxes to a foreign government, these taxes count as a dollar-for-dollar credit against any Federal tax liability.

"Profits made in Indiana are taxed when earned. And taxes paid to the State of Indiana can only be taken as a deduction against gross income rather than a Federal tax credit. The Foreign Trade and Investment Act will plug both of these gaping loopholes through which American capital, technology and jobs have poured."

Senator Vance Hartke, February 27, 1972

In hopes of reducing domestic unemployment, the sponsors of the Burke-Hartke bill would curb direct investment abroad through tax increases and direct controls, prohibit or tax the international transfer of technology, and severely cut back the level of imports by means of tight quantitative restrictions. These changes would mark a fundamental departure from the traditional U.S. policies of promoting the two-way expansion of trade and furthering the free flow of capital. This paper principally examines the proposed changes in the taxation of foreign earnings. Although it strongly supports the objective of increasing employment, the paper concludes that the means proposed in the Burke-Hartke bill would be self-defeating.

The paper makes a comparison of international tax burdens in eight countries where U.S. direct investments loom large. Further, it analyzes the tax principles underlying existing U.S. treatment of foreign subsidiary income. Even though tax differentials have seldom, if ever, been a significant reason for foreign direct investment in the past, it is emphasized that tax increases could force the liquidation of foreign direct investments and the forfeiture of foreign markets both in the country of investment and in third countries and put an end to investment abroad in the future. Accordingly, the

paper examines the domestic employment record of multinational companies and analyzes the question whether less investment abroad would mean more jobs at home. It discusses the likely impact of the Burke-Hartke bill on the American economy and — finding that it would be adverse — concludes with the outline of a positive economic program to accomplish what Burke-Hartke would fail to do — increase the level of employment and raise the general prosperity of the U.S. economy.

SUMMARY

The tax provisions of the Burke-Hartke bill are founded on the mistaken premise that foreign direct investment is largely made because of tax advantages abroad. This is not borne out by the facts as evidenced by the comparison herein of U.S. income tax burdens with the comparable burdens borne by U.S. subsidiaries incorporated in eight major foreign countries. In addition to the levying of income taxes at national and local levels abroad, the subsidiaries' earnings are subject to withholding tax when they are paid out as dividends to the U.S. parent and, in turn, such dividends may also be subject to U.S. income taxes. The comparisons show that foreign direct investment entails no tax advantages relative to U.S. investment, in a number of major countries such as Canada, where the burden is 56.2%, compared with 50.9% (federal and average state taxes) in the United States. Where there is an advantage abroad, it is not great. For example, the effective rate is 45.8% in Germany. The weighted burden for the eight countries studied was 51.1%, which is slightly higher than in the United States. Thus, taxes have generally not been the motivation for the establishment of foreign operations or for their local incorporation. Rather, there are other and fundamental reasons which govern the rationale for making foreign direct investments. (See NFTC study.)[1]

The United States uses the nationality principle of taxation, namely, that U.S. residents are liable for the same U.S. income tax whether their income originates at home or abroad. This principle further tends to eliminate taxes as a factor in the determination of investment locations. A problem of double taxation arises, however, because other countries impose a tax on the income of U.S. residents originating within their borders. To mitigate this problem and to recognize the prior claim to taxation by the nation in which the income arises, the industrial nations of the world have adopted one of two systems. One is to allow a credit for foreign taxes paid, the other is to exempt foreign income from home country taxes. The United States uses the former system as do Canada, Germany, Japan, Mexico and the United Kingdom. The credit is limited to the U.S. income tax liability associated with foreign source income, assuring that the tax burden will be the higher of the U.S. or the foreign tax on such income.

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[1] "The Impact of U.S. Foreign Direct Investment on U.S. Employment and Trade - An Assessment of Critical Claims and Legislative Proposals," National Foreign Trade Council, Inc., November, 1971.

The provisions of the Burke-Hartke bill pose the question of why foreign income taxes should be allowed as a tax credit rather than as a deduction from income as are state income taxes. We would agree as a matter of tax neutrality that a credit should be granted for state income taxes to eliminate their role as determinants of investment location; however, the crediting of state income taxes without strict limitations would tend to eliminate pressure on the states to control expenditures and taxes. The credit for foreign taxes does not have this tendency because tax increases by foreign governments are borne mostly by their own nationals and this operates as an effective restraint on escalation.

The deductibility for foreign taxes that would result under the Burke-Hartke bill would enormously increase the tax burden on the earnings of foreign subsidiaries (from about 50% to 75%) and would render U.S. investments abroad uncompetitive.

In addition to eliminating the foreign tax credit, the Burke-Hartke bill would compel a U.S. parent corporation to report as taxable income not only the foreign subsidiary's earnings it actually receives as dividends but also the earnings which are not distributed but are reinvested abroad. This would be a breach of the fundamental U.S. tax principle of treating a corporation as a separate entity from its shareholders. There would be no justification for the corporate tax if shareholders were taxed on undistributed corporate earnings, since such treatment would amount to defining shareholders themselves as the corporate entity, paralleling the the treatment of partnerships. If U.S. shareholders were required to pay taxes on the reinvested as well as the distributed earnings of their foreign corporations, they would be discriminated against in comparison with shareholders in domestic corporations, whose taxes on corporate earnings apply only to the portion of those earnings actually distributed as dividends. Today no country taxes the undistributed earnings of a foreign operating subsidiary.

The domestic economic performance of multinational corporations belies the underlying assumption of the Burke-Hartke bill that foreign direct investment results in the export of jobs. Survey studies clearly indicate that multinational manufacturing enterprises expanded their U.S. employment faster than U.S. manufacturing employment as a whole during the decade of the sixties. The same holds for their domestic output, investment and exports. The charge that they invested abroad in order to supply the U.S. market is inconsistent with the facts. Not only are U.S. imports from foreign affiliates small — less than 8% of their total sales — but U.S. foreign investments have been relatively small in most product areas such as steel, textiles and footwear where import competition has been particularly intense.

Notwithstanding these facts, would multinational corporations have expanded their domestic employment even faster had foreign investment been

precluded? For employment to have been higher in the absence of foreign investment, exports or domestic investment would have had to have been greater. But there is compelling evidence that neither exports nor investment at home were reduced by reason of foreign investment. American-made products are often not competitive abroad — whether because of free market factors or government restrictions — so that foreign direct investment is essential if the United States is to have a hand in serving such markets. And if U.S. investors were precluded from capitalizing on investment opportunities abroad, those opportunities would be seized by the investors of other countries. The realistic question is not whether foreign investment is to occur, because it will in any event, but whether its advantages will accrue to the United States or to other countries.

The Burke-Hartke bill would not achieve job expansion and domestic economic growth. On the contrary, the provisions of the bill are so burdensome that they would not simply restrain U.S. foreign direct investment but would seriously disrupt American investments abroad — old as well as new — and in the process both undermine the health of the domestic economy and reduce its job-creating potential.

The bill would raise the tax burden on foreign earnings in the eight countries compared from the present range of 45.0% - 56.2% to a range of 71.4% - 77.2%. At these tax levels, U.S. foreign affiliates would no longer be able to compete with foreign-owned firms. The alternatives for their parent companies in the United States would be grim. To survive, some might be compelled to liquidate or sell their foreign affiliates. Others would lose their competitive positions as higher remittances from abroad to pay the new taxes would reduce funds available for modernization and expansion abroad, possibly even to the extent of interfering with the amortization of outstanding loans.

Enactment of the regressive provisions of the Burke-Hartke bill could trigger reprisals against U.S. investments abroad by countries already resentful over the extraterritorial application of certain U.S. laws. The bill would impair the significant contributions that foreign direct investments make to our balance of payments. Direct investment outflows would be replaced by foreign borrowings in the United States, to permit foreigners to seize upon opportunities denied to American companies through the traditional foreign direct investment process. Moreover, U.S. purchases of foreign equities would probably rise as individual American investors endeavored to participate in growth opportunities abroad that would be closed to U.S. multinational companies.

The Burke-Hartke bill does not address itself to the fundamental causes of unemployment. These are mainly the economy's cyclical downturn, the loss of international competitiveness through inflation, the shift in national priorities away from defense-oriented activities, and the changed composition

of the labor force. A positive economic program for increasing employment must be responsive to these basic causes, which do not include investment abroad.

Fundamentally, expansive monetary and fiscal policies are called for — and are being implemented — to remedy cyclical unemployment and bring the economy back to the full utilization of its human and industrial resources. Structural unemployment should be eased through effective programs to improve the functioning of labor markets and provide adjustment assistance. The already negotiated currency realignment should be instrumental in paving the way for a restoration of the U.S. international competitive position. These policies should be supplemented, as appropriate, by programs to moderate inflationary expectations and excessive wage and price increases.

It can be argued that transitional import restrictions, imposed as a result of escape clause determinations, can play a role in easing the burdens of adjustment to changing international competitive forces. So-called "orderly marketing" quotas or other restrictive measures, however, could threaten the whole climate, both here and abroad, for maintaining sound international trade and investment policies. These should be carefully appraised not only in terms of their effect upon the particular industry concerned but also in terms of their effect on our national security and on our economy as a whole. The true national interest lies in an open, multilateral trading and investment system and not in adopting policies of defeatism and isolationism.

I. "GAPING LOOPHOLES"? — THE FACTS

The issue of "gaping tax loopholes" raises a question of fact. The basic relevant question is whether U.S. corporations invest abroad because of the prospect of paying lower taxes than would be required at home. The answer to this question requires an international comparison of total income tax burdens on investment. Such a comparison, using current statutory tax rates for nine leading countries, is provided in TABLE A. The table does not attempt to quantify the impact on tax burdens of differences in tax accounting rules among the various countries because of the practical difficulty of securing reliable data for relating such rules to representative business transactions and investments.

The aggregate taxes shown in the table consist of the income and dividend withholding taxes of the subsidiary's country of operation and incorporation plus the income tax levied by the parent company's country on dividends received. In the second line of the table, for example, the Canadian subsidiary of a U.S. corporation is compared first with a Canadian-owned corporation operating in Canada, and with the Canadian subsidiaries of parent companies in each of the other eight nations.

The comparisons in the table refute the notion that foreign investment is motivated by the desire to avoid high domestic taxes. U.S. direct investments in most of the countries shown bear roughly the same tax burden as do domestic investments. Significantly, the heaviest burden of all — 56.2% vs. 50.9% in the U.S. — results from investments in Canada, where the book value of U.S. manufacturing investments is more than twice as high as in the next ranking foreign center for such investments. The average of total tax burdens on U.S.-owned foreign subsidiaries in the eight countries compared, weighted by the book value of U.S. manufacturing investments in 1970, is 51.1%, which is slightly higher than the U.S. burden of 50.9% counting both federal and average state income taxes. Even where the tax burden is lower — as for example in Germany (45.8%), Britain (45.0%), and Japan (47.8%) — the differences relative to the U.S. rate are too small to constitute significant incentives for foreign investment. (See TABLE A.)

These modest differences moreover are offset by the general propensity of other countries to apply higher indirect taxes than prevail in the United States. This is an element of tax burden not included in the data shown on TABLE A. Tabulated below are the percentages of tax revenues derived by the U.S. and foreign governments from indirect taxation which emphasize the dimensions of this burden.

United States	30.4%
Canada	48.4
France	42.9
Germany	39.4
Italy	41.3
Japan	39.6
Mexico	N.A.
Netherlands	29.6
United Kingdom	47.2

TABLE A

A COMPARISON OF THE CURRENT EFFECTIVE TAX RATES ON INCOME EARNED BY WHOLLY-OWNED MANUFACTURING SUBSIDIARIES OPERATING IN SELECTED COUNTRIES WITH SUBSTANTIAL U.S. INVESTMENT
(All Amounts Expressed in Percentages)

Subsidiary's Country of Operation and Incorporation	Parent Company's Country of Operation and Incorporation									
	United States	Canada	France	Germany	Italy	Japan	Mexico	Netherlands	United Kingdom	Net Income Distributed
United States	50.9									
Canada	56.2	53.0	56.2	56.2	56.2	56.2	56.2	56.2	56.2	45.8
France	51.2	56.2	50.0	50.0	53.7	53.7	56.2	50.0	51.2	49.1
Germany	45.8	45.8	43.6	39.1	45.8	50.3	50.3	50.3	50.3	73.2
Italy	53.9	57.0	57.0	61.8	52.3	61.8	61.8	52.3	52.3	66.2
Japan	47.8	48.7	48.7	47.8	49.6	46.0	49.6	49.6	47.8	32.9
Mexico	48.5	48.5	48.5	48.5	48.5	48.5	42.0	48.5	48.5	55.7
Netherlands	48.6	47.5	47.5	49.7	47.5	53.0	53.0	47.5	48.6	41.9
United Kingdom	45.0	45.0	41.7	45.0	40.0	43.3	52.8	41.7	40.0	55.0

Notes: The 50.9% rate for a U.S. corporation operating domestically takes into account the Federal income tax of 48% and average state income taxes of 5.6% as reduced by the federal income tax deduction. Likewise, the rates shown for other countries include local income tax effects.

Because withholding and home country taxes depend on amounts remitted, it was necessary to consider the percentages of after-tax earnings distributed to the parent companies (payout ratios). To make the table as realistic as possible, the payout ratio underlying the calculations for each country is the arithmetic average of actual payout percentages of U.S.-owned manufacturing subsidiaries incorporated in that country in the period 1960-1970, as shown in the last column (source: unpublished Commerce Department data). For the sake of comparability, the same payout ratios were applied to all companies operating in the same country. In Germany, when subsidiaries simultaneously pay out earnings and increase their debt or equity capital, an added 10% withholding tax is applicable to any portion of distributed earnings that is deemed to be reinvested. Typically the German authorities apply this added 10% tax when the percentage of net income distributed is as high as the 73.2% shown in the table. If 23.2 percentage points of this payout is deemed to be reinvested (implying a 50% net payout ratio), the effective tax rate is 47.2%.

Differences in the rates paid by the various nationalities reflect variations in tax-treaty dividend withholding rates between countries.

It has been assumed that the total income of the wholly-owned subsidiary was earned within the taxing jurisdiction in which it operates.

Of the countries shown above and, indeed, of 43 countries ranked according to the percentage of tax revenues from indirect taxes, only the Netherlands has a lower percentage than the United States.[2] These facts and the earlier comparisons of income tax rates scarcely support the notion that American investments abroad can be explained in terms of attractive foreign taxes. Many of the countries where U.S. investments loom large levy taxes higher than those at home. Thus, the contention that U.S. companies go abroad to avoid U.S. taxes is implausible on its face. In fact, numerous foreign subsidiaries were established long before the advent of the U.S. income tax.

Fundamental business considerations typically dictate foreign direct investment as the only way of gaining access to foreign markets that would otherwise be closed to the United States. As explained more fully in Section IV, where the job effects of overseas investment are discussed, there may be no alternative to manufacturing abroad in the face of large differences between domestic and foreign production costs, high transportation costs, currency controls, foreign trade barriers made more effective by the creation of common markets and free trade areas, local content requirements, perishable products, discriminatory government procurement practices and on-site inspection requirements.

The proponents of the Burke-Hartke bill are mistaken in contending that, when U.S. companies venture abroad, they choose to incorporate their foreign operations so that foreign earnings "are not taxed until they are repatriated." There are compelling legal reasons for choosing the corporate form of doing business abroad. An increasing number of countries require local incorporation by all foreign investors as a prerequisite for doing business. Those who do not go so far may require local incorporation as a condition for operating in such areas as mining, petroleum, real estate, pipelines, transportation, public utilities, shipping, banking and insurance. Operational reasons for incorporating abroad include such basic considerations as gaining favorable access to local money and capital markets; identifying with the local markets for goodwill purposes; qualifying for financial advantages available only to local corporations; conducting operations not permitted to other than local corporations; gaining such exchange preferences as may be available to local companies; lessening adverse criticism directed at foreign companies; and accommodating the preferences of host governments, employees, and customers, all of whose attitudes and actions can determine the success or failure of the enterprise.

[2] "Fiscal Figures", by David Perry, *Canadian Tax Journal*, July-August 1971.

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II. "GAPING LOOPHOLES"? — THE PRINCIPLES INVOLVED

A. Tax Credits

One of the underlying principles of the U.S. tax system is that residents are taxed on their incomes regardless of whether the source is domestic or foreign. The objectives are broadly twofold, namely, to achieve equity by applying equal income taxes to U.S. taxpayers having the same amount of income irrespective of the country in which that income is derived, and to minimize the role of taxes as determinants of industrial location by striving for tax neutrality as between investments at home or abroad.

The application of this U.S. principle to the foreign source income of U.S. citizens is complicated by the exercise of the primary tax jurisdiction over such income by host countries. As does the United States, other countries exercise their fundamental and prior right to tax all income generated within their borders regardless of owner nationality. Thus, when the United States asserts tax jurisdiction over foreign-generated income, international accommodation among countries is required to prevent the pyramiding of different layers of taxation on the same income base. This problem, commonly known as double taxation, would tend to destroy the neutrality of our tax system by raising the combined tax rates on U.S. foreign source income above the domestic rates. To avoid this problem of double taxation and to recognize that the nation where the income arises has a prior claim to tax income, industrial nations of the world have adopted either one of two systems. One method, employed by the United States, as well as Canada, Germany, Japan, Mexico and the United Kingdom, is to apply generally the same tax structure to the worldwide income of its citizens but to allow a credit for foreign income taxes paid on income earned abroad to the extent of the home country tax on such foreign income. The use of the credit system by the United States, in effect, assures that a U.S. resident will pay the higher of the U.S. or the foreign tax on his income from abroad and is consistent with our goal of tax neutrality. The system used by some other countries is to exempt from home country tax all foreign source income realized by their nationals. This approach is generally employed by France, Italy, and the Netherlands, for example.

The Burke-Hartke bill raises the question of why foreign income taxes should not be treated in the same way by the federal authorities as are state income taxes, namely, as deductions from taxable income rather than as credits against tax liabilities.

As a matter of tax equity, state income taxes should be treated in the same way by the federal authorities as are foreign income taxes. But in principle the equality of treatment should be achieved by making state income taxes a credit rather than by making foreign income taxes a deduction. The existing system of the United States amounts to double taxation of the same corporate income. And it has led the states to use their corporate tax rates as instruments of competition in attracting corporations to their territories. As a result, taxes in the United States are not neutral with regard to location, a fact which militates against optimal efficiency in resource allocation. The system has been tolerable only because state income taxes are relatively low — five states have none, and rates range from 2% to 12% in the other 46 jurisdictions among which the District of Columbia is included.

However, there is a practical difficulty in shifting from the present system of deduction to allowing a tax credit for state income taxes. If not accompanied by strict limitations, it would tend to eliminate pressure on the states to control expenditures and taxes and they could and undoubtedly would force the federal government into uncontrolled revenue sharing by raising their taxes without, at the same time, risking taxpayers' revolts. On the other hand, experience shows that the credit for foreign taxes does not have this tendency because tax increases by foreign governments are borne mostly by their own nationals and this operates as an effective restraint on escalation.

The case for keeping the foreign tax credit is compelling. Foreign income tax rates, unlike state income tax rates, are generally as high as the U.S. rates. If these income taxes were treated as a deduction rather than a credit, American companies would no longer be able to compete in operations abroad. Through no fault of their own, companies who, in good faith, based their prior decisions on long-standing, generally accepted tax principles would suffer an impairment of earning power and a destruction of capital value. To illustrate this point, the following tabulation (based on the same payout ratios used in TABLE A) shows the total effective tax rate of a U.S. parent company operating a wholly-owned foreign subsidiary in each of the eight foreign countries.

Local Tax Jurisdiction Of Subsidiary	Effective Tax Rate		
	Under Burke-Hartke Bill	Under Present Laws	Percentage Increase
Canada	77.2	56.2	37.3
France	74.6	51.2	45.7
Germany	71.8	45.8	56.8
Italy	76.0	53.9	41.0
Japan	72.9	47.8	52.5
Mexico	73.2	48.5	50.9
Netherlands	73.3	48.6	50.8
United Kingdom	71.4	45.0	58.0

The result would be to eliminate American business ventures in foreign countries. This is recognized by both sides of the aisle in Congress. For example, the then Assistant Secretary of the Treasury for Tax Policy, Stanley S. Surrey, in testimony in the late 1960's at hearings before the Senate Foreign Relations Committee with respect to the proposed United States-Brazil income tax treaty, reiterated a fundamental and accepted premise:

> "American investment would not proceed at all without the foreign tax credit because then, as the Chairman pointed out, two taxes would be imposed and the over-all burden of two taxes would be so great that international investment would practically cease."

B. U.S. Taxation of Controlled Foreign Subsidiaries

Is the U.S. principle of taxing income regardless of source breached, as the Burke-Hartke proponents contend, by taxing U.S. shareholders on the income of their foreign subsidiaries when distributed to such shareholders rather than when earned by the subsidiary?

In our view the answer to this question is no, for what is at issue here is not whether foreign source income should be taxed, but whether such taxation should occur before the income to which it applies is actually realized. The earnings in question are the earnings of foreign corporations owned by American corporate shareholders. The United States does not now tax these earnings and the Burke-Hartke bill does not propose to do so. It is therefore not meaningful to speak of "deferred" taxes in this context. Moreover, there is no tax deferral when the foreign subsidiaries pay dividends to their U.S. parent companies, because then U.S. income taxes apply fully. In seeking to tax a U.S. parent company's share in the earnings of its foreign subsidiary before dividends are received, the Burke-Hartke bill would actually accelerate the payment of U.S. income taxes, not eliminate any deferral of taxes. The Burke-Hartke proposal is really an attempt to tax indirectly undistributed earnings of operating subsidiaries abroad which the United States cannot tax directly because they are foreign corporations.

Today there is no country which taxes undistributed earnings of a foreign operating subsidiary. In fact, more than 25 countries never tax earnings of foreign subsidiaries regardless of whether such earnings are distributed or not.

In seeking to tax undistributed earnings of foreign subsidiaries, the Burke-Hartke bill would discriminate against U.S. shareholders in foreign corporations as against shareholders in domestic companies. The latter would continue to be taxed only on their dividend income, not on the undistributed earnings of the corporations in which they have an equity. This is consistent with sound tax principles. A corporation is, and should be, treated as an entity separate from its shareholders. There would be no justification for the corporate tax if shareholders were taxed on undistributed corporate earnings, since such treatment would amount to defining shareholders, themselves, as the corporate entity, paralleling the treatment of partnerships. This reasoning applies to individual and corporate shareholders alike.

Nor can it be reasonably urged that the proposal for taxing undistributed earnings is needed to prevent tax abuse. Existing sections of the Internal Revenue Code dealing with foreign personal holding companies, tax haven situations and allocation of income and expense items are in fact preventing abuses. Moreover, as pointed out earlier, when foreign tax rates are considered in the areas where U.S. foreign investments are concentrated, there is on balance no tax advantage. Thus, there is no justification for departing from the well-established principle of taxation and the universal practice of other countries that a parent company should not be taxed on the undistributed earnings of its foreign subsidiaries.

Not only would the Burke-Hartke bill violate the principle that income should be taxed only when received, but also it would violate the principle that income should be taxed equally whether domestic or foreign. The bill would not allow foreign subsidiary

income in one year to be adjusted for events in a subsequent year, such as operating losses, devaluations, expropriations, and exchange controls. These could reduce the number of dollars ultimately remaining for payout below the amount actually required to pay the U.S. tax. In contrast, adjustments to domestic income are permitted to recognize such developments. One example is the operating loss provisions which permit business losses in one year to offset taxable income in other years.

The principle of equal taxation of income regardless of source would also be violated by the Burke-Hartke bill which would deny accelerated depreciation on property located outside the United States, while such depreciation would continue to be permitted on property at home.

Finally, the same principle of equal taxation would be at stake in the proposal to tax the gain on the transfer of patents, inventories, etc., to a foreign subsidiary in an otherwise tax-free reorganization whereas a similar transfer to a domestic subsidiary is and would remain tax free.

III. HAVE JOBS BEEN EXPORTED?

The attacks on investment abroad for allegedly exporting jobs, which began a number of years ago, have resulted in proposals to change the taxation of U.S. foreign direct investment, such as those in the Burke-Hartke bill. Effective refutations of such attacks have been developed by our Government, academic groups, various trade organizations, and individual businesses.

Recent studies have revealed that, far from exporting jobs, American companies actively expanding their foreign investments actually increased jobs at home at above average rates — a result of their pacesetting growth in domestic output, both for home consumption and export, and of their rapid increase in home investment. This finding stems from the fact that in today's integrated world economy opportunities for expansion abroad go hand in hand with similar opportunities at home. The ability of the same companies to expand simultaneously at home and abroad is largely explained by this synchronized development of opportunities, together with dynamic, aggressive managements able to capitalize on such opportunities and positive linkages between overseas investment and U.S. exports.

A recent survey by the Emergency Committee for American Trade (ECAT)[3] shows that 74 leading multinational corporations in manufacturing expanded their United States employment by 36.5% between 1960 and 1970, not counting increases through acquisitions, nearly two and a half times as rapidly as the 15.3% increase for all manufacturing industries over the same period.

Domestic sales by the ECAT respondents rose 99% from 1960 to 1970, whereas the total value of shipments of manufactured products in the United States grew by only 71%. Only one of the ten ECAT industry groups failed to expand its domestic sales as rapidly as the average for all U.S. manufacturing. And this failure may be only apparent, not real, for the survey covered only 5% of the industry concerned — primary and fabricated metal products — too small a sample to yield reliable results.

This survey also shows that these companies increased their investments in the United States more rapidly than did all manufacturing industries. Cumulative expenditures for plant and equipment, not counting acquisitions by the 74, grew 93% between 1961-65 and 1966-70, compared with 71% for the U.S. industry total. One-third of the respondents stated that foreign investments had been a cause of greater investment at home by stimulating exports. Only 5 of the 74 firms stated that foreign investment had resulted in lower domestic investment by reducing potential export growth.

The ECAT survey further shows that the 74 multinationals increased their exports of manufactured products by 181% between 1960 and 1970 — substantially faster than the 124% growth of total U.S. manufactured exports in the same period. Between 1965 and 1970, their exports grew 85%, compared with 64% for the country as a whole.

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[3] "The Role of the Multinational Corporation in the United States and World Economies," Emergency Committee for American Trade, Washington, D. C., February 24, 1972.

A detailed industry analysis by Professor Robert G. Hawkins[4] both confirms and further emphasizes the positive relationship between investment abroad and domestic expansion that has been noted in other surveys. An examination of comprehensive Commerce Department data for 19 manufacturing industries led to the conclusion that the industries with the highest rate of expanding investment abroad tended to have the most rapid growth in domestic output and employment. Conversely, the industries with the slowest investment growth abroad tended to experience the least expansion in home output and employment. Analysis of 39 sub-industries containing the largest foreign investments in manufacturing generally supported the results of the more aggregated comparisons. In Professor Hawkins's words, "It appears that MNC operations abroad are more a product of the relative dynamism of the industry and the firms involved — both domestically and overseas — than of the switching of the locus of production of a fixed level of output among countries."

Finally, as demonstrated in the NFTC survey, supra, and corroborated by other studies, there is no support in the facts for the contention that to a significant degree U.S. companies have shifted plants or high-level technology abroad for the purpose of supplying the U.S. market with the output of low-wage foreign labor.

The ECAT survey, supra, discloses that only 2.5% of the total sales of American-owned manufacturing subsidiaries abroad were made to the U.S. in 1970, excluding increased motor vehicle trade, mainly under the 1965 Canadian-American auto pact which aimed at expanded two-way trade in autos and parts. Inclusion of the auto trade would raise that figure to 8.9%. These survey results are generally confirmed by more comprehensive data collected by the Commerce Department. In 1968, the latest year available, sales to the U.S. by foreign manufacturing affiliates of domestic firms were 5.9% of their total sales, excluding autos from Canada, and 7.9% including those autos. These low percentages effectively refute the notion that foreign investment is a vehicle for transferring from the hands of Americans to foreigners the work of supplying the home market.

Moreover, the sectors where the inroads of imports into the domestic market have been most rapid and extensive are not generally sectors where U.S. direct investments abroad loom large.

Evidence from the NFTC survey indicates that foreign investments giving rise to imports back to the United States are concentrated in a few industrial sectors and a few components or simple products, and not ones incorporating high technology. This was confirmed in a recent publication by the Commerce Department which noted that:

"...the rapid growth of U.S. imports in recent years has not been due solely, or even mainly, to the multinational corporation. Most of the increase has come from sources other than the foreign affiliates of U.S. firms. German, Japanese, and other exports of automobiles, steel, textiles, footwear, and electronic goods

[4] "U.S. Multinational Investment in Manufacturing and Domestic Economic Performance," Occasional Paper No. 1, Center for Multinational Studies, Washington, D. C., February 1972.

"...have very successfully entered the American market without the benefit of ties with U.S. corporations." [5]

In a current report, moreover, the U.S. Tariff Commission states:

"...industries characterized by heavy overseas investment in productive facilities appear also to be those which not only contribute most heavily to U.S. exports but also have had the least impact on the upsurge of U.S. imports--with exactly the reverse results appearing for those industries in which strong foreign investment activity is not characteristic." [6]

Additional evidence challenging the labor viewpoint that the operations of multinational corporations adversely affect the growth of employment can be found in a 1970 detailed study by the Tariff Commission[7] concerning tariff items 807 and 806.30. These items, which permit certain duty-free exemptions for U.S.-origin goods re-entering the United States have been under sharp attack by organized labor groups, which have advocated repeal of the duty-free exemptions. In its study, the Tariff Commission reported that the repeal of these two tariff items:

"...would not markedly reduce the volume of imports of the articles that now enter the United States under these provisions. Rather, the products would continue to be supplied from abroad by the same concerns but in many cases with fewer or no U.S. components, or by other concerns producing like articles without the use of U.S. materials. ... Repeal would probably result in only a modest number of jobs returned to the U.S., which likely would be more than offset by the loss of jobs among workers now producing components for exports and those who further process the imported products." [7]

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[5] "The Multinational Corporation - Studies in U.S. Foreign Direct Investment," U.S. Department of Commerce, Volume I, March 1972.

[6] "Competitiveness of U.S. Industries," Report to the President, U.S. Tariff Commission, Publication 473, Washington, D. C., April 1972.

[7] "Economic Factors Affecting the Use of Items 807.00 and 806.30 of the Tariff Schedule of the United States," Tariff Commission Publication #339, September 1970.

IV. WOULD THE BURKE-HARTKE BILL LEAD TO MORE JOBS AT HOME?

In further considering the basis for the proposed tax measures, one must analyze the critics' claims that, even if foreign investment is not a cause of domestic unemployment, curbing such investment can lead to job expansion at home. In their view, the demonstrable expansion of domestic employment by firms investing abroad illustrates merely that the firms concerned are enjoying rising demand for their products in several areas of the world and not that their foreign investment is a direct cause of higher employment at home. Reasoning further that production abroad is a substitute for exports as a means of supplying foreign markets, these critics conclude that, no matter how rapidly U.S. foreign investors expanded their exports from the United States, their export performance would be better still if foreign investment were discouraged. Larger exports would, of course, mean greater domestic production and this, in turn, would mean more jobs.

But would lower foreign investment really mean more jobs? It is easy enough to see, on balance, that foreign investors did not cut U.S. employment. That is a simple matter of fact easily verified by the empirical evidence. There is no comparable way, however, of settling the question at hand, which deals with what might be if things were different from the way they actually are. The only effective way of resolving such a question is to make detailed, in-depth studies of individual investment situations and attempt to trace through the job implications of alternative courses of action.

Studies that have been made establish that curbing foreign investment would not increase jobs at home, mainly because foreign markets could not be supplied on competitive terms through exports. These studies demonstrate that foreign investment is necessary to enter markets that would otherwise be impregnable because of competition from other foreign investors enjoying the benefit of lower production costs and, in addition, is essential to overcome obstacles such as trade barriers, transportation costs, perishability of products, local content requirements, on-site inspection requirements and government procurement practices. (See NFTC study supra.)

Professor Raymond Vernon of Harvard University has developed a product-cycle theory to explain shifting patterns of exports and overseas production.[8] He notes that, over the years, technical innovation has provided U.S. manufacturers with new distinctive products which early in their life cycles permit foreign markets to be developed through exports despite relatively high wage rates and sometimes raw material costs at home. As these overseas markets grow and as the products concerned begin to age, a foreign manufacturing base becomes necessary to prevent sales from being preempted by local imitators who can capitalize on lower labor costs and other local advantages. A decline of U.S. exports of the products concerned is therefore unavoidable, even in the absence of U.S. overseas investment, but such investment can at least maintain an American presence in foreign markets and give the United States the benefit of profit remittances.

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[8] See "Sovereignty At Bay - The Multinational Spread of U.S. Enterprise", by Raymond Vernon, Basic Books, New York, 1971.

The critics may yet argue on other grounds that stemming the outflow of capital would raise domestic employment. Some contend that, to a significant degree, domestic and foreign investments are mutually exclusive and that foreign investment materially reduces the amount of domestic investment that would occur in its absence. This, like many of the issues raised by the Burke-Hartke legislation, is basically a question of fact. Does foreign investment preempt domestic investment? The surveys conducted by NFTC and ECAT inquired into this matter. Findings of the NFTC survey indicate that foreign direct investment tends to expand U.S. exports and thereby stimulate both domestic investment and employment in the United States, even though this may involve some shifts in the structure of employment in this country. Likewise, the majority of ECAT respondents emphasized that foreign investment leads to higher domestic investment because of export stimulation; few referred to the point emphasized by the critics, namely, the alleged negative impact of foreign investments on the availability of funds for domestic projects. Of those responding to this question, all but one stated that their foreign programs were independent of their domestic programs, and therefore had no adverse impact on domestic investment expenditure. Basic to this exercise of independence is the availability of foreign funds to finance investments abroad.

On this score, the latest comprehensive statement of sources of funds for U.S.-owned foreign affiliates[9] shows that, in manufacturing, capital from the United States accounted, on average, for only 12.6% of total investment abroad in the most recent five years for which consistent data are available — 1963-65 and 1967-68. To be sure, this low percentage of U.S. source funds partly reflects capital contributions by foreigners with whom, in many cases, American parent companies share ownership. And in the 1965-68 period, reliance on U.S. source funds was probably subnormal, because the government's balance of payments programs placed great stress on the overseas financing of foreign direct investment. Still, the average percentage of U.S. source funds in 1963-64, before these balance of payments programs were instituted, was 11.0%, lower even than the five-year average. Despite these qualifications, it remains a striking fact that only $1 from the United States was associated with each $8 of actual investment abroad by U.S.-controlled foreign affiliates during the period covered.

At most, therefore, only a small fraction of each dollar actually invested abroad could be lost to the home economy. And even this fraction would be lost only if the U.S. portion of the overseas investment dollar came at the expense of domestic investment. But there are good reasons for believing that little, if any, does. To be sure, at the level of the individual company, fund limitations could require a marginal choice between investing at home or abroad. This raises the possibility that preventing a firm from investing elsewhere might induce it to expand at home into projects that would not otherwise be profitable enough to warrant approval. But even at the individual company level, the result of restricting foreign investment might simply be lower total investment and not expanded investment at home. In any event, what is true for a company need not be true for the economy. Indeed, capital outflows tend to be offset by government policies aimed at maintaining domestic stability. These policies help to maintain a high

[9] "Sources and uses of Funds of Foreign Affiliates of U.S. Firms, 1967-68," *Survey of Current Business*, November, 1970.

level of investment at home, except during periods of monetary and fiscal stringency imposed to counter inflation. By their very nature, these compensatory policies tend to prevent foreign investment from displacing domestic.

Because foreign investments tend to supplement rather than supplant domestic inventment, their effect on the domestic economy is positive in the long run by actually increasing the amount of funds available for both investment and consumption at home. This positive effect is a consequence of the return flow of funds from U.S. foreign investments. Over the years, remittances of dividends, interest, branch earnings, fees and royalties have risen more rapidly than capital outflows from the United States, with the result that, since 1967, U.S. investments abroad have returned annually around $2 of purchasing power for every American dollar currently sent out for foreign expansion. This return flow would be jeopardized by the provisions of the Burke-Hartke bill. Unless U.S. investments abroad are permitted to continue, the rising trend of remittances would be reversed.

The critics might even shift their focus from the effect of foreign direct investment on income flows to its effect on domestic credit availability and terms. They, in fact, argue that foreign direct investment reduces the liquidity of U.S. financial markets and drives up interest rates — two tendencies that reinforce each other in depressing domestic investment. In this line of thought, however, they do not adequately consider the offsetting effects of the domestic stabilization policies to which earlier reference has been made. Monetary policy, in particular, tends to become more expansive when capital outflows rise to prevent the adverse effects on the domestic economy feared by the critics.

Moreover, the critics may not appreciate the underlying linkages between direct investment abroad and foreign borrowing in the United States. Among the reasons for making foreign direct investments is the prospect of higher rates of return than could be realized at home because productivity of capital abroad is at a higher level than in the United States. However, this also tends to raise the level of interest rates abroad above the U.S. level. If the critics were to have their way by restricting foreign direct inventment, any tendency of interest rates to fall at home might simply stimulate foreigners to shift their borrowing from local credit markets to the United States. American loans abroad would then be substituted for U.S. foreign direct investment, but the effect on domestic liquidity would be comparable for money would flow from the country in either event and higher foreign demands for credit would tend to sustain the level of U.S. interest rates. This further underscores the conclusion reached earlier that restricting foreign direct investment is not a realistic means of increasing domestic investment.

V. OTHER ECONOMIC CONSEQUENCES

On general considerations, curbing foreign direct investment would not appear to be a promising means of promoting domestic employment and growth. And the Burke-Hartke bill, in particular, would fail to achieve these goals. The provisions of this bill are so burdensome that they would not simply restrain U.S. foreign direct investments; they would seriously disrupt American investments abroad — old investments as well as new — and in the process undermine the health of the domestic economy and reduce its job-creating potential.

Let us examine the pressures that Burke-Hartke legislation would apply to U.S. foreign investments. It is necessary only to refer to TABLE A on page 9 which shows the additional tax burden on U.S. foreign direct investments if the Burke-Hartke bill were enacted. The table shows that the tax burden for U.S. subsidiaries abroad would rise in the eight countries from the present range of 45.0% - 56.2% to a range of 71.4% - 77.2%. The tax burden on the subsidiaries of other countries, however, would remain at present levels or generally 20 to 30 percentage points lower than the rates of taxation that would apply to U.S. subsidiaries operating abroad if the Burke-Hartke bill were enacted.

The proposed tax treatment is so onerous that American parent companies might be forced to sell or spin off their foreign investments. Such actions could disrupt foreign capital markets which, lacking the depth, breadth and resiliency of American securities markets, would be hard pressed to absorb any significant portion of the $78 billion book value, in 1970, of U.S. direct investments abroad. Moreover, attempts to repatriate the proceeds of any such sales could result in balance of payments disruptions and would tend to create friction between the United States and foreign governments. Needless to say, distress sales of foreign assets would harm the interests of U.S. shareholders and the American economy generally. The liquidation of investments abroad would deprive the domestic economy of the continuing expansionary thrust of dividends, royalties, service fees, and interest payments that flow from these investments, thereby frustrating the objective of promoting more jobs and growth at home. Liquidations would reduce the scope of American research and development efforts, weakening the U.S. competitive advantage in advanced technology. And such liquidations would undermine U.S. exports by breaking the link between domestic manufacturing and foreign assembly and distribution, the strength of which depends on the parent-subsidiary relationship.

Parent companies able to avoid the liquidation of their foreign subsidiaries would face a painful dilemma. If the Burke-Hartke bill were enacted, the only way they could minimize their increased tax burden would be to encourage their foreign subsidiaries to reduce dividends. Remittances would only increase the total tax burden on foreign earnings if foreign source profits were taxed whether remitted or not and if the foreign tax credit were eliminated, for remittances are subject to foreign withholding taxes while reinvested earnings are not. But a reduced flow of dividends from abroad, coupled with higher taxes on the parent company, could squeeze corporate liquidity at home to the detriment of domestic output and employment.

On the other hand, U.S. parent companies could jeopardize the viability of their foreign subsidiaries if they were compelled to increase dividend remittances from abroad to

obtain the means for paying higher taxes. This would reduce retained earnings for development and expansion abroad needed to remain competitive, and could force borrowings in the open market at higher costs. It could be decisive in a company's ability to continue in business in the face of foreign competition for the same market. Furthermore, such repatriation could prevent a company from meeting its contractual obligations on repayments of loans where earnings are so committed.

In connection with the economic consequences of the Burke-Hartke legislation, it becomes important to consider the reactions of certain foreign governments. In the past we have witnessed varying adverse reactions to U.S. policy decisions, for example, the application of our anti-trust laws and export controls to U.S. foreign subsidiaries and affiliates as well as the pressures since the middle 1960's, both under the voluntary program and the mandatory controls over foreign direct investments, on international companies to increase their repatriations of earnings.

The foreign direct investment program emphasized that we were faced with an emergency and that the program would be temporary in nature. Neither of these qualifications, however, would apply to the changes proposed under the Burke-Hartke bill which would be permanent. These changes could also create conflicts with other shareholders in foreign subsidiaries which are not wholly-owned and in some instances the other shareholders are agencies of the government of the countries in which the subsidiaries are located. Consequently, an even stronger foreign reaction could be anticipated if the Burke-Hartke bill should be enacted. It would be only realistic to anticipate countermeasures which could range from restrictions on remittances to the imposition of special discriminatory taxes against subsidiaries of U.S. corporations.

The Burke-Hartke bill would seriously weaken the U.S. balance of payments position. Discouraging U.S. investments abroad would not cause American exports to rise, as has already been explained, but would provide profitable opportunities for our foreign competitors. As these opportunities would be seized upon, some portion of the capital needed for their expansion could be expected to be obtained in the U.S. capital market. Outflows of dollars resulting from the sale of debt and equity securities in the United States would be substituted for capital exports formerly associated with American direct investment abroad. In due course, remittances of subsidiary profits would accordingly dwindle and, since direct investments generally earn higher returns than portfolio investments, the United States would lose one of the most dynamic contributors to balance of payments receipts of recent years. Moreover, the higher taxes that the Burke-Hartke bill would levy on U.S. corporations would discourage foreigners from investing in U.S. firms with overseas operations. (As recently as 1968, foreign purchases of U.S. equities totalled $2.3 billion.) At the same time, capital outflows would be stimulated as individual American investors endeavored, by acquiring foreign equities, to seize the opportunities for participating in growth abroad which the Burke-Hartke bill would deny to U.S. multinational companies.

The U.S. balance of payments would also suffer from the elimination of the exclusion from U.S. taxes on earned income of U.S. citizens working abroad. This would likely reduce the number of Americans who are both equipped with the necessary technical

skill and know-how and are willing to work abroad. This reduction, in turn, would result in the lessening of American exports and business abroad and ultimately in lower taxable revenues for the U.S. government. Should industry attempt to compensate for the elimination of the exclusion by raising the pay of those Americans affected, then U.S. business interests would be burdened with a competitive disadvantage at a time when its foreign competitors are formidable giants.

The U.S. balance of payments and domestic employment would both be impaired as innovation and productivity slackened in response to a diminished market for American technology. If the Burke-Hartke bill prohibited or taxed the exploitation abroad of research results, including patent rights, U.S. industry would be deterred from carrying out in the United States research projects whose ultimate profitability depended on greater breadth of application than would be possible in the United States alone. At the same time, the Burke-Hartke bill would provide strong encouragement for a shift of such research abroad. Not only would research done by U.S. foreign subsidiaries be free from the technology transfer restrictions of the bill, but the bill's general tax provisions would supply powerful incentives for a shift of corporate functions, including research and development, from the United States to the subsidiaries. By raising the effective tax rate on foreign subsidiary earnings from about 50% to approximately 75%, the bill would make the after-tax cost of a dollar of foreign expense around 25 cents compared with roughly 50 cents in the United States. Thus, it would be cheaper to perform research abroad than at home.

Here, as elsewhere, the consequences of the Burke-Hartke bill would be exactly the opposite of what its proponents intend. A significant number of jobs would be exported. The total research efforts of American multinational companies would probably decline. U.S. leadership in technology advances would be undermined as the United States became increasingly dependent on technology and patents developed abroad. And the balance of payments would be further weakened by increased outflows of royalties to foreign countries.

Some companies, wishing to maintain freedom of action in exploiting their technologies, might choose to maintain patentable inventions in the form of trade secrets rather than obtain U.S. and foreign patents. This too could weaken the U.S. technological and balance of payments positions, since it would lead foreign competitors to develop similar technologies, patent them, and then restrict their use by the originating U.S. companies.

Many developing countries might view the Burke-Hartke bill to be particularly severe on the developing world. These countries could view the bill as a further requirement of American corporations to repatriate more of their profits at a time when many of them maintain that such repatriation is already excessive.

There is more at stake for the United States here than the financial interests of private investors. For example, American investments in the developing world are heavily concentrated in the extractive industries producing materials essential to the national security of the United States. To be sure, ownership has not been a prerequisite to availability of

supplies in the past. But scarcity is rapidly replacing abundance and, in the future, American investments abroad may be necessary to assure that the vital interest of the United States does not easily fall victim to the preemption or diversion of essential materials by competing foreign investors — state-owned corporations, perhaps — dominated by ideological or political considerations inimical to U.S. interests.

More generally, the adverse effect of the Burke-Hartke bill on foreign direct investment, on which the developing countries continue significantly to rely for their growth, could frustrate development plans, increase political instability and support the goals of those who espouse economic nationalism. Our vital interests dictate encouragement and not discouragement of the substantial contribution that private foreign investment can make toward economic growth, stability and prosperity in host countries.

VI. TOWARD A POSITIVE ECONOMIC PROGRAM

The Burke-Hartke bill is an attempt to deal with the problem of high and persistent domestic unemployment. There is no disagreement among thoughtful and responsible Americans that economic policies should be pursued to provide a job for everyone seeking work within a general framework of reasonable price stability. The ends are not in question. What is in dispute is the means. As this discussion of the Burke-Hartke bill has illustrated, not all policies intended to create jobs can have that effect. The Burke-Hartke bill would fail because it does not meet a key requirement of a successful policy. It is not responsive to the fundamental causes of the problem. It thus becomes necessary to identify the causes and explore what should be done about them.

There are four basic reasons why the United States suffers from a serious unemployment problem today. None of them involves foreign direct investment. The first and foremost reason is that the U.S. economy has undergone a recession from which its recovery is still incomplete. This recession resulted principally from Government efforts to end the rampant inflation of recent years. The Government's strategy was to end demand-pull inflation by eliminating excessive purchasing power and to choke off cost-push inflation by increasing employer resistance to high wage claims as product markets softened. Unfortunately, inflationary pressures were so intractable, even in the face of the Government's determined efforts, that the economy was caught in the proverbial squeeze between an immovable object and an irresistible force. The result was a recession and the serious problem of high unemployment.

The second reason is a corollary of the first, namely, a loss of international competitiveness because of inflation and low productivity as well as a resulting loss of markets at home and abroad to foreign competitors. This need not have contributed to unemployment if the U.S. dollar could have been devalued in time to prevent serious overvaluation. But its role as an international reserve currency delayed such a devaluation until American competitiveness was already impaired. The U.S. problem was exacerbated by the tendency of other countries on balance to devalue their currencies against the dollar in the post-war period, thus intensifying the eroding effects of inflation on the U.S. trade balance.

The third reason is the decision to generally reduce military expenditures and cut back on aerospace programs. An expanding economy could have facilitated the absorption of employees whose jobs were eliminated in aerospace and other defense-oriented industries or who were released from the armed forces. But such an absorption was not possible in a recession economy. Thus, structured unemployment was added to unemployment from cyclical causes.

Finally, unemployment rose even as the number of jobs grew, because the labor force was significantly increased by large numbers of youngsters reaching working age and by women, many of them married, seeking employment for the first time. Such unemployment, while undoubtedly less critical than the actual loss of jobs by heads of families, nevertheless calls for action to assure that the growth of job opportunities keeps pace with the increasing number of job seekers.

A positive economic program for increasing employment must be responsive to these basic causes, which it is again pointed out do not include investment abroad. Fundamentally, expansive monetary and fiscal policies are called for to remedy cyclical unemployment and bring the economy back to the full utilization of its human and industrial resources. Such policies are now being implemented. These policies should be supplemented, as appropriate, by programs to moderate inflationary expectations and excessive wage and price increases.

Recent currency realignments should be instrumental in paving the way for a restoration of the international competitive position of the United States. Together with further success in the fight against inflation and effective policies to increase productivity, the dollar's new exchange rate should in time help to restore a U.S. trade surplus. In the interim, the United States should assume leadership in negotiating an improved international monetary system with other countries. The problems of joblessness in defense industries and among teenagers and women point to the need for structural programs, including the development of a nation-wide system of bringing job seekers and prospective employers together, retraining programs for workers and managers in declining industries, and comprehensive efforts to guide the vocational thrust of U.S. education in directions that promote a matching of skills with future opportunities.

All of these are measures consistent with expanding both the level and quality of employment. They deal with causes not merely with symptoms. And significantly, they do not include measures to curb investment abroad or to restrict imports.

Import restrictions, also called for by the Burke-Hartke bill, would be no more successful than curbs on overseas investment in increasing domestic jobs, and could provoke foreign reprisals not only against U.S. exports but against foreign investment. Under the General Agreement on Tariffs and Trade, if a country increases trade barriers on some products, its trading partners are entitled to receive offsetting, equivalent reductions in the barriers on other products. And if these are not forthcoming, they are allowed to increase their own import barriers against the offending country's exports to restore the pre-existing balance in trading relations. Under none of these alternatives can the intitating country achieve an improved trade balance.

Above all, trade restrictions are not necessary to increase jobs for a nation that keeps itself competitive in world trade through effective domestic and external policies. Such a nation can have both full employment and the benefits of international specialization. Trade then serves to raise the quality of employment by shifting jobs into the relatively efficient high-wage industries and away from the relatively less efficient, low-paying sectors of the economy.

The outward looking policies suggested here imply continuing shifts in the structure of output and employment in response to changing competitive forces. From time to time, the pace of change may outstrip the ability of particular domestic firms and industries to adjust without serious hardship or injury. If the threat of injury results from predatory foreign practices as, for example, dumping or subsidies, forceful and prompt action to apply countervailing duties is called for. In general where injury or the threat of injury is established,

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adjustment assistance should be provided to the workers and firms concerned. If such assistance alone would fail to meet the need, consideration should then be given to temporary increases in trade barriers. Added import restrictions, however, should not be across the board protecting healthy and afflicted sectors alike. They should be limited to those imports responsible for the domestic injury. Moreover, increases in trade barriers imposed as a result of escape clause determinations should remain in effect only for a transition period while the efficiency of existing operations is improved or resources are shifted into fields with better prospects. So-called "orderly marketing" quotas or other restrictive measures, however, could threaten the whole climate, both here and abroad, for maintaining sound international trade and investment policies. These should be carefully appraised not only in terms of their effect upon the particular industry concerned but also in terms of their effect on our national security and on our economy as a whole. Trade barriers should not be permitted as indefinite shelter against the force of change — save only where such barriers are essential to safeguard the national security. Change and adaptation are the keys to economic progress for other countries as well as for the United States. U.S. policies should aggressively seek to expand export opportunities and actions should be taken to rectify the unfair trade practices of others. Moreover, the United States should spearhead a new multilateral attack on trade barriers. Our nation's interests lie in an open, multilateral trading and investment system that propels economies to the outer limits of their productive potential and not in adopting policies of defeatism and isolationism.

COMMENT ON THE ERICKSON-MILLSAPS PAPER PUBLISHED BY THE JOINT ECONOMIC COMMITTEE, JULY 15, 1972

(By the American Petroleum Institute Division of Taxation)

The Joint Economic Committee, Congress of the United States, published a compendium of papers on July 15, 1972, pertaining to so-called tax subsidies which included a paper "Taxes, Goals, and Efficiency: Petroleum and Defense" by Professors Edward W. Erickson and Stephen W. Millsaps.[1] The paper was the basis for oral testimony by Professor Erickson before the Joint Economic Committee on July 21, 1972. The following comment on the Erickson-Millsaps paper has been prepared by the Division of Taxation, American Petroleum Institute.

The Erickson-Millsaps paper appropriately recognizes the significance of national security—especially the risk of "political boycotts by oil producing states"—as a primary consideration in evaluating petroleum taxation. Beyond this, the paper's principal conclusions are highly doubtful. They are, indeed, often in conflict with the analysis in the paper—or its primary sources. This is particularly evident in the analysis of neutrality, risk, and the CONSAD report. Other important considerations, such as the total tax burden of the industry, are disregarded in their paper. This critique is concerned with the specific issues raised by Professors Erickson and Millsap.

NEUTRALITY OF RESOURCE ALLOCATION

The paper concludes—quoting Professor McDonald—that the Federal petroleum tax provisions have had an un-neutral effect by inducing "an uneconomical allocation of resources to petroleum." That is, even though "the corporate income tax as we know it is definitely not neutral"[2] (Professor Harberger), the petroleum tax provisions over-correct for the mal-allocation of resources which would occur *against* oil if there were no distinctive tax provisions. Professor McDonald actually said that "it is not now possible to say conclusively" whether the petroleum tax provisions do over-correct.[3] He conjectured that the majority of professional economists would believe that there is an over-correction, *provided that* one ignores other taxes. Immediately after saying (p. 299) "there are important mis-allocative effects" (the end of the Erickson-Millsaps quotation), he said:

> The analysis and conclusions, however, abstract from taxes other than income taxes. In the context of the entire national tax system, it is possible that distinctive tax treatment of income from oil and gas is more nearly consistent with the ideal of neutrality.[4]

It is *very* possible that distinctive tax treatment is consistent with neutrality, since the over-all domestic tax burden of the oil industry is a higher percentage of gross revenue than is the case for all industry—5.8% (exclusive of refined product excise taxes) vs. 4.7%.[5]

Furthermore, the Erickson-Millsaps paper itself points out that the over-correction in *favor* of oil (if any) may be smaller than the discrimination which would occur *against* oil with a uniform corporate income tax. In that event, they admit (p. 299) that they would have to conclude that "the existence of special tax provisions is more desirable than their absence." No one knows with any certainty whether percentage depletion over-corrects; but in an industry as vital to national security and economic growth as is petroleum, it is surely better to err, if err one must, on the side of over-allocation rather than under-allocation of resources.

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[1] Joint Economic Committee, Congress of the United States, *The Economics of Federal Subsidy Programs, Part 3—Tax Subsidies*, pp. 286–304.

[2] Arnold C. Harberger, "The Corporation Income Tax: An Empirical Appraisal," in U.S. House of Representatives. Committee on Ways and Means, *Tax Revision Compendium*, (Washington, 1959), p. 232.

[3] Stephen L. McDonald, "Distinctive Tax Treatment of Income from Oil and Gas Production," in University of New Mexico School of Law, *Natural Resources Journal*, January, 1970, p. 110.

[4] *Ibid.*, p. 112.

[5] Petroleum Industry Research Foundation, Inc., "The Tax Burden on the Domestic Oil and Gas Industry, 1967–1970," (New York, 1972), p. 11.

RISK AND UNCERTAINTY

The Erickson-Millsaps paper asserts that petroleum exploration is not particularly risky. Furthermore, it concludes (p. 295) that the risks are, in effect, insurable by engaging in large exploration programs:

> If a firm were to drill 99 wells, it could expect about 11 successes, although it would not know in advance which of the wells would be the successful ones.

This computation is based on an extension of industry results to the individual operator. It is inappropriate.

In the first place, the "remarkably stable" ratio to which they refer has, in recent years, been closer to 1 in 10 than 1 in 9. This ratio has changed since the early 1960's and it may change again. The Erickson-Millsaps position is (p. 295) that a changing ratio does not effect their conclusions. However, this is only true if the change in the ratio is known with certainty beforehand—and this is by no means the case in petroleum exploration.

Moreover, the argument confuses new field wildcat wells initially reported as productive of oil or gas with "success". All such wells are by no means successful. Consider the following results for 1965 as evaluated after 6 years of experience:

	Number of wildcats	Percentage of total wildcats
Total wildcat wells drilled	6,182	100.0
Originally reported discoveries	638	10.3
Originally reported discoveries which were extensions of old fields	38	.6
Revised discoveries	600	9.7
Discoveries abandoned since 1965	93	1.5
Discoveries still productive in 1971	507	8.2
Of which—		
Fields averaging 500,000 barrels [1]	410	6.6
Fields averaging 5,000,000 barrels [1]	73	1.2
Fields over 10,000,000 barrels [1]	24	.4

[1] Or equivalent gas at 6,000 cubic feet=1 barrel.

Source: Computed from AAPG data in Oil and Gas Journal, May 29, 1972, p. 83.

This tabulation shows clearly that the bulk of the 1-in-10 "success" ratio is atributable to very small fields averaging only half a million barrels of oil (or an equivalent amount of gas). As a rule of thumb fields with only half a million barrels of oil will not yield a profit. In terms of fields of 10 million barrels of oil or more (or an equivalent amount of gas) which generally are profitable, the ratio is more like 1-in-250 than 1-in-10.

Professors Erickson and Millsaps draw an analogy to roulette which is hardly "apt"—particularly the analogy to red versus black and odd versus even. One can confidently say that the probability of red or even in roulette is about 1-in-2. But the probability for commercially successful oil and gas exploration is actually even worse than the 1-in-36 probability for an individual number at roulette.

The percentage of total wildcats finding a 10-million barrel field, or better, averaged 0.3% during 1959–1968 (the last ten years for which data are available), with an annual range of 0.2 to 0.4%. But, even if the chances of success were precisely 0.3%, the laws of probability state that a 100-well wildcat program would find *no* such fields three times out of four. A 100-well wildcat program is a big program for even the large companies. Furthermore, with the 0.2–0.4 spread in the *industry* results, it is clear that the wildcatting results of *individual* drillers must vary even more widely. The concept of saftey in numbers simply does not stand up under scrutiny. Even very large firms show wide variations in average results per dollar of exploration and drilling effort, both from year to year and compared to each other.

Furthermore, the large-number approach is not conceptually appropriate for petroleum exploration in any event since the oil and gas explorer exploits individual prospects. He does not drill the whole United States, or the whole world, or even a whole state on a probabilistic basis. He evaluates individual structures.

> In view of the wide range in the percentage of significant hits and in the average size of fields found by wildcat producers, it is apparent that the degree of success for the industry is generally unpredictable. It is definitely unpredictable for any one test or any 10 or 11 tests or nine tests, since new ventures are evaluated individually on the basis of the geological characteristics of each prospect. Exploratory tests are never drilled on the basis of national wildcat producer ratios.[6]

Petroleum exploration is not analogous to even the most risky part of roulette. In fact, petroleum exploration is characterized by a high degree of uncertainty (in the Knightian sense), not by insurable risk.[7] Industries of this type are particularly susceptible to the un-neutrality of the uniform corporate income tax.

CONSAD

The Erickson-Millsaps paper relies heavily on the 1969 CONSAD study even though the authors recognize (p. 301) that when CONSAD "estimated the change in the desired level of reserves for elimination of percentage depletion, elimination of expensing intangibles, and both . . . they assumed production was held constant."

As described by CONSAD:

> The CONSAD study was aimed at determining the effectiveness of the special tax provisions in increasing reserves above those levels needed solely to support production.[8]

CONSAD was merely trying to determine the percentage reduction in reserves which would be desired for a given level of production in the event of a price reduction equivalent to the value of the Federal petroleum tax provisions. This question is of little or no interest in evaluating the national security significance of the petroleum tax provisions, since it ignores the possibility that an increase in taxes could lead to a decrease in production.

It was hardly to be expected that CONSAD would come up with a large percentage answer to its question. If production does not change, the desired level of reserves will also not change to any noticeable degree, since the optimum reserve/production ratio is largely technologically fixed—as CONSAD, itself, observed:

> There is a definite technological relationship . . . between the stocks held and the level of production. This limits the amount that can be produced from a given level of stocks, and requires a producer to maintain certain levels of stock to meet certain levels of production.[9]

CONSAD knew that when production does not change, the desired level of reserves does not change. Yet CONSAD still went through an elaborate statistical exercise to find out how much reserves would change if production did not change.

Furthermore, the Erickson-Millsaps paper concluded (p. 287) that there was a "defect in the basic model" used by CONSAD, such that CONSAD even understated the answer to its own question. Professors Erickson and Millsaps were concerned because the CONSAD model erroneously assumed that the industry was in long-run equilibrium. (In fact, there was excess capacity throughout the CONSAD base period.) There are a number of other conceptual problems with the CONSAD study (see the attached summary analysis of it), not the least of which is the ability of a model of the type chosen to answer the question asked. Professor Griliches has said, *in regard to models of this type*, that

> One cannot answer the question of what happens to the rate of investment . . . if a change occurs in depreciation rules.[10]

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[6] Testimony of Jack H. Abernathy, U.S. House of Representatives, Committee on Ways and Means, *Hearings on the Subject of Tax Reform*, (Washington, 1969), Part 9 of 15, p. 3159.

[7] Frank H. Knight, *Risk, Uncertainty, and Profit*, (New York, 1964), pp. 197–232.

[8] CONSAD comments on industry rebuttal of the CONSAD study.

[9] CONSAD, "The Economic Factors Affecting the Level of Domestic Petroleum Reserves," (Washington, 1969), p. 7.3.

[10] Z. Griliches, "Comment on Crockett-Friend and Jorgenson," in Robert Ferber, ed., *Determinants of Investment Behavior*, (N.Y.: NBER, 1967), p. 161.

But it is just such a shift in tax policy, which CONSAD attempted to appraise since depletion is evaluated in the model as depreciation would be. Even if CONSAD had asked the question which is important for national security purposes, one should not accept the Erickson-Millsaps contention (p. 302) that the "only" available study (CONSAD) must be used for public policy evaluation when they admit that the study is, in fact, basically defective. Thus, the CONSAD study simply cannot support the conclusions which Professors Erickson and Millsaps drew from it.

NATIONAL SECURITY

The important question for national security is the effect of the tax provisions on the *over-all* level of domestic production and reserves. This, as CONSAD has observed, is a very different matter from *its* subject:

> The question studied by CONSAD was that of the effectiveness of the tax incentives in inducing petroleum producers to hold reserves *larger* than those *necessary* to support production. This is a different question (and would be expected to have a substantially different answer) from the question of the effects of the tax incentives on the *total* level of reserves.[11]

The Erickson-Millsaps paper notes (p. 295) that the primary national security danger today is "political boycotts by oil producing states." In order to determine how the United States would fare in the event of a boycott, the relevant question is the degree of dependence on insecure overseas sources. What part of the nation's requirements can be satisfied from secure sources? What is the over-all level of domestic productive capacity (and reserves required to support that capacity)? And how would these be affected if the Federal petroleum tax provisions were abolished?

Based on historical data, Professor Erickson has, himself, estimated econometrically that a 10% decrease in price would ultimately mean about a 10% decrease in reserves.[12] Based on an evaluation of domestic geological prospects remaining for future exploitation, Humble Oil & Refining Company has estimated that a 10% decrease in price would ultimately mean about a 17% decrease in reserves and production. [13] (Other oil companies and the Department of the Interior foresee even larger reduction.)[14] Depending on a company's individual situation, percentage depletion is today equivalent to 15% to 20% of the value of oil and gas produced [22% statutory rate less the effects of (1) the limitation to 50% of net income and (2) the minimum tax on tax preferences.]. If one assumes that the depletion allowance is equivalent to 17%, on average, the Erickson and Humble studies would indicate that elimination of percentage depletion would ultimately reduce U.S. production by 17% and 28%, respectively, with an accompanying increase in dependence on overseas supplies. (The only significant uncommitted reserves are the Middle East.) If the tax increase were passed on to consumers, production could be maintained. However, Professor Erickson estimated in oral testimony that domestic crude oil would then cost 15 to 20% more. Loss of the intangible expensing provision would cause a further decrease in production, unless offset by price increases.

What would be the national security significance of such decreases in the activity of the domestic industry? The 1970 report of the Cabinet Task Force on Oil Import Control found that the national security requires that Eastern Hemisphere imports be "an absolute maximum" of only 10% of domestic requirements.[15] The United States is, today, producing oil at capacity in the lower 48 states; and domestic production accounts for about 75% of total requirements. Eastern Hemisphere imports are rising and are between 5 and 10% of total re-

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[11] Robert F. Byrne and Wilbur A. Steger (CONSAD), "Assessment of the Effectiveness of Federal Tax Incentives for Natural Resources," in Tax Institute of America, *Tax Incentives*, (Lexington, Massachusetts, 1971), p. 100.

[12] Originally in Edward Erickson, *Economic Incentives, Industrial Structure and the Supply of Crude Oil Discoveries in the United States, 1946–58, 1959*, Unpublished Ph.D. Dissertation, Vanderbilt University, 1968; updated in Charles River Associates, *An Analysis of the United States Oil Import Quota*, (Lexington, Massachusetts, 1970), pp. 220–227.

[13] See Testimony of M.A. Wright, U.S. House of Representatives, Committee on Ways and Means, June 3, 1970. A price reduction from $3 to $2 was expected to lead to a 55% decrease in discoveries.

$$\frac{3-2}{3}=33\% ;\ 55\% \div 33\% = 1\tfrac{2}{3} ;\ 1\tfrac{2}{3} \times 17\% = 28\%.$$

[14] See Testimony of Robert C. Dunlop, U.S. Senate, Committee on Finance, *Hearings on H.R. 13270 to Reform the Income Tax Laws*, (Washington, 1969), Part 5 of 7, p. 4464.

[15] Cabinet Task Force on Oil Import Control, *The Oil Import Question*, (Washington 1970), p. 98.

quirements. If the domestic industry were now 17% smaller (the Erickson-type estimate for percentage depletion alone), another 13% of United States requirements would be coming from the Eastern Hemisphere [13%=17% of 75%].

CONCLUSION

In his oral remarks, Professor Erickson described the neutrality debate as "absurd" and as an *ex post facto* attempt to rationalize percentage depletion. But if neutrality is not a valid criterion for tax policy, why (for at least 20 years) have certain academic economists continually criticized percentage depletion for bringing an uneconomically large amount of resources into oil? That criticism has not been justified. Indeed, the neutrality debate among academic economists has shown that some speciality of tax treatment is needed merely to reestablish neutrality toward this vital industry, which is capital intensive and differentially risky.

However, Professors Erickson and Millsaps are correct in concluding that national security is a vital consideration (even though they are incorrect in disregarding other valid considerations). In a period when the nation is rapidly approaching 10% dependence on Eastern Hemipshere oil—with higher dependence imminent—some air of unreality does surround relatively esoteric professional economic arguments about whether the nation has over-committed resources to the search for domestic petroleum reserves. Elimination of percentage depletion without a compensating price increase would mean significantly less domestic production and a corresponding increase in the nation's dependence on insecure overseas oil sources.

Attachment

THE CONSAD REPORT ON THE INFLUENCE OF U.S. PETROLEUM TAXATION ON THE LEVEL OF RESERVES, MID-CONTINENT OIL AND GAS ASSOCIATION, WASHINGTON, D.C.

SUMMARY

The conclusions of the CONSAD report can be given no credence because:

I. The mathematical formula (an "economic model") from which the conclusions are drawn is conceptually inappropriate for the purpose.

II. CONSAD, itself, issues repeated warnings about the pitfalls of its model-building. The combined impact of these cautions is a clear signal that CONSAD should have rejected this model, as it did two other models—and as it did *this* one for natural gas.

III. The quality of the data used in the formula is questionable, as is the method of manipulation.

IV. There are factual errors in the report.

V. The study proceeds from a number of doubtful premises about the economics of the petroleum industry.

I. INAPPROPRIATENESS OF THE CONSAD FORMULA

The CONSAD study employed mathematical methods to predict the change in petroleum reserves that would result from elimination of percentage depletion. A fundamental error was made by using a formula that cannot answer this question. It was assumed that *production would not change* in the event of an increase in petroleum taxation, and the formula was designed to determine the level of reserves that would be required to accommodate the assumed fixed level of production.

Once it made the assumption that output is fixed regardless of profitability, it was inevitable that CONSAD would find that there would be little change in the desired level of reserves, since the required level of reserves is technologically determined by the level of production. It is indisputable, owing to the nature of petroleum deposits, that any given level of production requires a supporting amount of reserves which is a multiple of production—as CONSAD acknowledges on page 7.3 of the report. (To produce one barrel of oil annually, there must be about ten barrels of supporting reserves in the ground.)

CONSAD actually ignored the *real* problem, which is how the long-run level of output would change in reaction to a decrease in profitability resulting from increased taxation. Instead, CONSAD indefensibly assumed that the desired level of production is independent of the level of profitability of the industry.

Indeed, the CONSAD model makes no provision for unprofitability (except at a zero price of crude oil). The mathematical model is so formulated that it tells us that the industry would find and develop reserves even if price were less than cost. Any model which states that businessmen desire to invest when price is less than cost is indefensible because no firm desires to invest at a loss.

II. CONSAD CAUTIONS

CONSAD raised such an extended and serious list of objections to its own procedures that the reader should be convinced of the mathematical formula's lack of merit without further independent inquiry.

The formula was developed for use in describing the behavior of individual firms in manufacturing. CONSAD questioned whether the formula would be reliable if extended to the petroleum industry—see page 6.31.

CONSAD also questioned whether the historical data employed can be used to predict the future—see pages 6.12 and 6.13. In the report, it was said that "If the quantity of reserves necessary to support a certain level of output has changed during the period of the study, it will cause errors" in the estimates—page 6.13. (In fact, the ratio of proved reserves to production actually *has* declined steadily since 1960.)

CONSAD warns that reliable economic models require reliable data. In addition to the problem of finding reliable figures, it was recognized that there are massive problems in using the data. Perhaps the best example is finding costs, "the most ambiguous area in the data in this study"—page 6.16. Computing industry finding costs involves multiple difficulties, e.g., (a) the impossibility of determining from industry data when the exploration dollars for a given year's discoveries were actually spent; (b) the difficulty of estimating how much has been found until a number of years after discovery; and (c) the random variability of the amount spent per barrel found from year to year.

III. STATISTICAL PROBLEM

The CONSAD report points out that there are "many missing links" in the quantitative data available for making a reliable economic study—page B.1. It nevertheless proceeded with the study on the basis of estimated data and often relied on doubtful stand-in data to estimate the effects of important items for which it could not obtain direct information. Moreover, the data were used to predict the effect of a change in industry taxation for which there is no historical precedent. Such an extrapolation beyond the range of historical experience violates fundamental statistical principles.

IV. INCORRECT INFORMATION

The report contains factually incorrect statements. Some involve data—even matters as basic as the current level of U.S. crude oil production. Others refer to petroleum tax provisions which do not exist.

If a research company is so unfamiliar with the petroleum industry as to err on basic data and tax provisions, it is unlikely to have sufficient knowledge of the industry to be able to develop accurate complex mathematical models for analyzing industry behavior.

V. DOUBTFUL PETROLEUM ECONOMICS

Some of the premises of the CONSAD study are, in our opinion, based on unreliable assumptions about the economics of the industry. A notable example of these propositions asserts that Canadian crude reserves can "substitute" for United States reserves. However, the amount of crude oil imports from Canada is limited by agreement between the two governments. Since crude oil imports from Canada are controlled, Canadian reserves—like overseas reserves—are not substitutes for U.S. reserves. Thus, CONSAD should not have aggregated Canadian and U.S. reserves in its economic model. And drawing conclusions from this model entailed the error of assuming that changes in the U.S. tax law would have the same effect on Canadian reserves as on domestic reserves.

CONCLUSION

No useful conclusions can be drawn from the CONSAD study because the mathematical model and the data are defective and because some of the basic premises are not appropriate. Indeed, it was predestined that CONSAD's exercise would be futile because CONSAD assumed that production would not change in the event of an increase in petroleum taxation.

Furthermore, we firmly believe that *no* aggregative mathematical model of the oil industry—no matter how sophisticated—can be used as a guide to estimating the effects of eliminating percentage depletion. Two of the most important reasons for this are:

(1) Part of the period upon which such a model must be based (the 1950's and 1960's) was one of the industry readjustment to excess capacity, a readjustment now well on the way to completion.

Sound statistical theory holds that projection of a past period assumes that any changes that occurred in the base period will be repeated in the future. Since further significant adjustment to excess capacity is not likely, the 1950's and 1960's cannot be used as a base period for forecasting the future.

(2) The largest year-to-year crude oil price change since 1950 was +30¢ per barrel (1956 to 1957). Elimination of percentage depletion would be equivalent to a price reduction of about 75¢ per barrel. Thus, any prediction of the results of such a tax change based on a model reflecting the 1950's and 1960's would require extrapolation far beyond the limits of the base period data.

Sound statistical theory holds that such extrapolation is invalid because there is simply no historical basis for evaluating how firms would react to changes so far beyond the range of experience.

CONSAD admitted the existence of these problems, but it proceeded undeterred.

Our criticism is not so much that CONSAD's exercise predictably proved futile, as that CONSAD drew serious public policy conclusions from its mathematical model despite the obvious and admitted statistical problems involved in constructing any such model. The model used is especially subject to critcism because it is based on the improper assumption that industry exploration and development expenditures are not dependent on an adequate rate of return.

Note: For the complete Mid-Continent analysis and comment with respect to the CONSAD report, see Part 5, pp. 4627–47 of the printed record of the public hearings by the Senate Committee on Finance on the Tax Reform Act of 1969, H.R. 13270, 91st Congress.

AMERICAN PETROLEUM INSTITUTE,
Washington, D.C. June 24, 1972.

Hon. LLOYD M. BENTSEN,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR BENTSEN: A considerable amount of misleading information has been circulated—frequently in anonymous materials directed to Members of Congress—to the effect that the petroleum industry does not bear its fair share of taxes.

Two separate factual studies of the petroleum industry's tax burden have recently been completed—one by Price Waterhouse & Company and the other by the Petroleum Industry Research Foundation, Inc. (PIRINC).

The study by Price Waterhouse & Company is a compilation of actual data for the year 1970 submitted to that accounting firm on a confidential basis by 18 major U.S. petroleum companies. Among the study's important findings are the following:

1. Total worldwide taxes of these 18 companies amounted to $21.9 billion. A projection of this figure indicates that the entire American oil industry had a tax liability in 1970 of approximately $27 billion.

2. Direct U.S. taxes borne by the 18 companies totaled $2.5 billion. This total consisted of $1 billion in U.S. Federal income taxes, $1.2 billion in state and local

direct taxes, and $300 million in Federal payroll and miscellaneous taxes. In addition, indirect U.S. taxes (mainly motor fuel and excise taxes) amounted to $7.2 billion. The total direct and indirect U.S. burden for the 18 companies was $9.7 billion.

3. Projecting these data to cover the petroleum industry as a whole results in a total U.S. tax burden of $14.0 billion—$3.5 billion in direct taxes and $10.5 in indirect levies.

4. Foreign taxes borne by the 18 companies totaled $12.2 billion. This figure includes $3.4 billion in income taxes, $6.0 billion in import duties and miscellaneous taxes, and $2.8 billion in indirect taxes. An industry-wide projection of total foreign taxes paid by U.S. oil companies is in excess of $12.8 billion.

5. For the 18 companies, the direct U.S. tax burden as a percentage of domestic gross revenues was about 6 percent. This percentage is higher than the average for U.S. corporations as a whole. If indirect taxes are included, the 18 companies' tax burden was 20 percent of domestic gross revenues—about three times as high as the average for all U.S. corporations.

The PIRINC study covers the four-year period 1967–1970 and confirms the data and conclusions derived from the Price Waterhouse survey. Among other things, the PIRNIC study establishes that for the year 1970 the domestic petroleum industry had a direct tax burden of 6.0 cents per dollar of sales and for the three-year period 1967–1969 the comparable figure was 5.8 cents per dollar of sales. These petroleum industry tax burden ratios exceed the tax burden ratio for the Internal Revenue Service classification "All U.S. Business Corporations" which was about 4.7 cents per dollar of revenue for the 1967–1969 period.

These two studies by Price Waterhouse and PIRINC factually refute the misleading distortions that have been asserted to the effect that the petroleum industry does not bear its fair share of taxes. An example of these distortions is the oft-repeated allegation that a selected group of oil companies (conforming almost exactly to the group in the Price Waterhouse study) had an effective Federal income tax rate of 8.7 percent of 1970 before-tax net income. This allegation is based on data which appeared on pages S 16896–8 of the *Congressional Record* of October 27, 1971. This alleged effective tax rate gives a totally misleading picture, for the following reasons:

1. It attempts to relate *domestic* Federal income taxes to total *worldwide* income. This ignores the substantial foreign taxes paid to host countries on income earned within their borders and the operation of the foreign tax credit which is designed to avoid the imposition of international double taxation on American taxpayers. Either domestic taxes should be compared to domestic income or worldwide taxes should be compared to worldwide income.

2. The Price Waterhouse study shows the effective U.S. income tax rate of the 18 companies to have been more than 2½ times the effective rate asserted in the erroneous data included in the *Congressional Record* insert.

3. Even this effective tax rate figure should be viewed in the light of the uniquely heavy direct tax burden imposed on the petroleum industry by state and local governments. In this regard the PIRINC study concludes that the petroleum industry's somewhat "lower effective income tax rate . . . is more than offset by its relatively higher burden of other direct taxes."

This is more than an academic dispute over numbers. Congress and the public are entitled to have accurate and factual information on which to make informed judgments. This is particularly true in light of the acute energy supply problem facing the country at this time.

U.S. energy requirements are projected to double by 1985 and the bulk of these requirements will have to be met by oil and gas. Nuclear and other forms of energy will play an increasingly important role in the long-term future but their impact will be largely felt after 1990. Meanwhile, we must rely on conventional energy sources—and particularly on oil and natural gas.

Our proved reserves of both crude oil and natural gas have dropped alarmingly in recent years. Simply stated, we are using more oil and gas than we are finding. The Chase Manhattan Bank has estimated that, if the U.S. is to maintain even a 75 percent self-sufficiency in petroleum supply, the domestic industry must invest $130 billion in the 1970's for exploration and development. This compares to total expenditures of $50 billion for these purposes in the 1960's.

To justify the commitment of investment capital on this scale to the high-risk and costly search for oil and gas, the economic environment must be such as to attract the needed funds. The tax outlook is a vital factor in determining that economic environment.

I sincerely hope that these two studies will contribute to an informed discussion of this question which is important to the petroleum industry but is also of vital importance to the nation and to the American consumer. If you would like copies of the Price Waterhouse and PIRINC studies, I will be most pleased to furnish them to you.

Sincerely,

FRANK N. IKARD.

EDISON ELECTRIC INSTITUTE,
New York, N.Y., July 26, 1972.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR PROXMIRE: In your opening statement at the Joint Economic Committee tax reform hearings on July 19 you noted that "These hearings will endeavor to provide careful analysis and debate on the Federal individual and corporate income tax systems."

The Edison Electric Institute, the principal national organization of the electric light and power companies in this country, is vitally interested in this subject because many of our member companies are in direct competition with electric power agencies that received Federal subsidies. The enclosed statement presents details on such subsidies and how they adversely affect Federal tax revenues. We ask that the statement be made a part of the hearing record.

We appreciate the opportunity to submit this statement.

Respectfully submitted.

W. DONHAM CRAWFORD,
President.

STATEMENT OF EDISON ELECTRIC INSTITUTE

The Edison Electric Institute submits this statement for inclusion in the record of the Joint Economic Committee's studies on tax subsidies and tax reform. The Institute is the principal national trade association of the investor-owned electric utility companies whose 184 members directly serve over 77 percent of the ultimate customers for electric service in the United States.

TAXES

The existence of disparate tax burdens on similar businesses calls for tax reform as a matter of equity and justice. Moreover, the correction of this type of inequity can generate substantial additional tax revenues.

In testimony before the House Ways and Means Committee of the 91st Congress Mr. Mortimer Caplin emphasized these points:

> The tax immunity of exempt organization businesses produces substantial losses of federal revenues. Even more serious, however, is the fundamental problem of unfair competition. The businesses with which the exempt organization competes must pay taxes on their earnings. The exempt organization, on the other hand, can make a variety of effective uses of the additional funds which it derives from its exemption. It may cut its prices below those which are economically feasible for its competitors. It may reinvest its tax savings in capital improvement and expansion programs * * * It is, in sum, permitted to wage business competition with a major and often decisive advantage over other businesses. (Hearings on Tax Reform Before the House Committee on Ways and Means, 91st Cong., 1st Sess., pp. 968–9.)

In the broad field of tax inequity between similar businesses one of the most flagrant instances of unequal treatment is in the electric power business.

The electric utility industry in the United States is composed of the investor-owned electric systems, which serve about 78 percent of all customers, and the government-owned and government-financed systems, which serve the other 22 percent.

The investor-owned electric systems pay federal income taxes, and state and local taxes. In 1970 these taxes amount to $3.4 billion, of which 35 percent ($1.2 billion) was federal income tax. The total of these taxes represented 17 percent of operating revenue.

In contrast, government-owned and government-financed electric systems pay no federal income tax, and as a broad class relatively little State taxes, local taxes, or payments in lieu of taxes. In 1970 their taxes and tax equivalents amounted to $193 million, which represented about 3.5 percent of their operating revenues.

The following table shows the 1970 operating revenues and tax payments of the several ownership categories of the electric utility industry.

Ownership	Operating revenues	Tax and tax equivalents	Percent of revenue
Investor-owned electric systems	$19,791,066,000	$3,426,641,000	17.3
Government-owned electric systems:			
Federal power agencies	826,600,000	19,154,000	2.3
Municipally-owned electric systems	2,389,676,000	86,904,000	3.6
State-district power agencies	786,178,000	29,596,000	3.8
Government-financed electric systems: Rural electric cooperatives	1,475,751,000	57,656,000	3.9
Total Government-owned and Government-financed systems	5,478,205,000	193,310,000	3.5

The above figures show that the government-owned and government-financed electric systems accounted for 22 percent of total operating revenues[1] of the entire industry, but paid only 5 percent of the taxes. Attachment A shows the comparatively low payments made by each category of government-owned and government-financed electric systems for taxes other than income taxes.

Since taxes on utility companies are an operating expense, which must be included in their rates and charges to customers, the effect of this inequity in our tax structure is to discriminate against the customers of the investor-owned electric utilities and in favor of the customers of the government-owned and government-financed power systems.

It is most unfair for 78 percent of the electric consumers in the country to have to pay in their electric bills 5 times the amount of taxes that the other 22 percent pay. And it is indeed anomalous that in a private-enterprise society customers of investor-owned enterprises are penalized by having to pay in the cost of their electric service substantially higher taxes than the customers of government-owned or government-financed electric systems.

One of the unfortunate aspects of this inequity is that if it is permitted to continue, the magnitude of the lost taxes will continue to increase, year after year—as both operating revenues and the tax component thereof continue to rise. As can be seen from Attachment B, the estimated annual taxes not paid by the government systems over the last 15 years grew from $365 million in 1954 to over $900 million in 1970—amounting to a total of $11 billion for the period. As the government-owned and government-financed systems continue to expand, they will be doing so at the expense of all the country's taxpayers, including those who are paying more than their fair share of taxes in their utility bills. Where two groups of America's electric customers, distinguishable only by the source of electricity, bear highly unequal tax burdens, tax inequality exists which rightly deserves the attention of this Committee.

There is no constitutional prohibition against equalization of the federal tax burden on consumers of electric energy. State and local governmental agencies engaged in business enterprises are not protected by the constitution against nondiscriminatory federal taxes. *Ohio vs. Helvering* (1934) 292 U.S. 360; *New York vs. United States* (1946), 326 U.S. 572; *Wilmette Park District vs. Campbell* (1949) 338 U.S. 411.

The rationale of these cases, as stated by the Supreme Court in *Ohio vs. Helvering* (p. 368), is simply that:

> Whenever a state engages in a business of a private nature it exercises non-governmental functions, and the business, though conducted by the state, is not immune from the exercise of the power of taxation which the Constitution vests in Congress.

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[1] In this same year, 1970, government-owned and government-financed power systems owned 23 percent of installed generating capacity of the electric utility industry.

COST OF MONEY

Because of the constantly increasing demand for electric energy the electric utility industry has been steadily expanding. This has created a constant requirement for new capital because funds generated internally have not been sufficient to cover the cost of new construction. Here again we find the same inequity that prevails with taxes—the government-owned and government-financed electric systems receive favored treatment with resultant discrimination against the customers of the investor-owned electric companies.

Investor-owned electric companies, the large municipally-owned systems, State and District power agencies and the Tennessee Valley Authority (since 1960) generally obtain funds by selling their bonds in the open market—in competition with each other and with other business enterprises.

Interest on securities issued by municipally-owned electric systems and state and district power agencies is exempt from Federal income tax and usually from state income taxes. Investors, especially those in the higher tax brackets, are understandably willing to accept lower interest rates on these securities than on securities which are not tax exempt.

The impact of these tax exemptions on the cost of money to investor-owned systems as compared with the cost of money to municipal systems is shown in the following table.

AVERAGE YIELDS ON CORPORATE AND MUNICIPAL BONDS[1]

Year (July average)	New corporate bonds, Aa rating (percent)	New municipal bonds, Aa rating (percent)
1961	4.81	3.43
1962	4.41	3.20
1963	4.34	3.08
1964	4.44	3.10
1965	4.57	3.20
1966	5.81	3.80
1967	6.06	3.90
1968	6.91	4.45
1969	8.06	5.60
1970	9.09	6.22

[1] Treasury Bulletin. April 1972. U.S. Treasury Department.

Some small municipally-owned electric utilities obtain their funds on an interest-free or low-interest basis direct from their respective municipal treasuries. The power agencies in the Department of the Interior follow a similar procedure, securing their funds from the U.S. Treasury through Congressional appropriations. Most rural electric cooperatives finance their money requirements through loans from the U.S. Treasury at the subsidized interest rate of 2 percent.

Previous to 1959, the Tennessee Valley Authority obtained its financing on an interest-free basis direct form the U.S. Treasury. Its investment by that time was over $1 billion. In 1959 the Congress required the Tennessee Valley Authority to finance its power program through the sale of long term bonds to the public and short term notes to the Treasury and the public. Federal income taxes apply to the interest on TVA's securities, but state and local taxes do not.

The Congress has never established an interest rate for treasury funds used by the Interior Department power agencies or by the U.S. Corps of Engineers, but did set a rate for funds used by the Bureau of Reclamation. This was done in 1939, and the rate was set at not less than 3 percent.

Until 1964 Interior power agencies (Bonneville Power Administration, Southwestern and Southeastern Power Administrations) were scheduling repayments to the U.S. Treasury at a nominal interest rate of 2½ percent. Since then, through Administration decree, the rate has risen slowly until in 1970 the rate reached a high of 4⅞ percent.

Under these various arrangements, the interest rate that Interior power agencies and the Corps of Engineers have been required to use for repayment of funds to the U.S. Treasury has generally been below the yield rate on long-term Treasury bonds. The result, of course, is a direct subsidy by taxpayers. Note the following comparison:

[In percent]

Year	Federal Power Agencies [1] repayment rate [2]	Average yield [3] rate on long-term treasury securities
1952	2.50	2.68
1955	2.50	2.84
1960	2.50	4.02
1965	3.125	4.21
1970	4.875	6.58

[1] Except TVA and the Bureau of Reclamation. Reclamation's interest repayment rate has not been below 3 percent since 1939.
[2] Various Water Resources Council publications.
[3] Statistical appendix to Annual Report of the Secretary of the Treasury, 1971.

Some idea of the size of the federal subsidy can be gleaned from the fact that Federal agencies had about $9.5 billion invested in power facilities as of 1970.

An even larger federal subsidy exists for customers of the rural electric cooperatives. Through 1970 practically all the funds invested by cooperatives in power facilities were received from the Federal Government through loans made by the Rural Electrification Administration at the nominal interest rate of only 2%, a rate well beneath even the nominal rates charged to Federal agencies for use of Federal funds. Loans at 2% interest by REA to cooperatives, public power districts and other public bodies totalled almost $7.5 billion through 1970.

It is questionable whether the original intent of Congress to subsidize power service to rural areas in need of such assistance is being implemented in an efficient and properly selective manner by the REA's interest subsidies to power agencies serving entire areas of the country—towns, suburban areas, and rural areas. They serve all classes of customers—residential, farm, commercial, industrial, and manufacturing. Aid intended for a particular category or class of people cannot be effectively achieved because the subsidy is spread among so many people and businesses—whether needed or not needed. Direct aid to such occupational or income classes as Congress determines are in need of aid would be a perferable and more economical system.

CONCLUSION

The Edison Electric Institute urges the following action by the Congress:

1. Elimination of an existing inequity in our tax structure and an increase in the Federal revenue by requiring presently tax-exempt electric power systems to pay Federal taxes equivalent to those now paid by tax-paying systems.

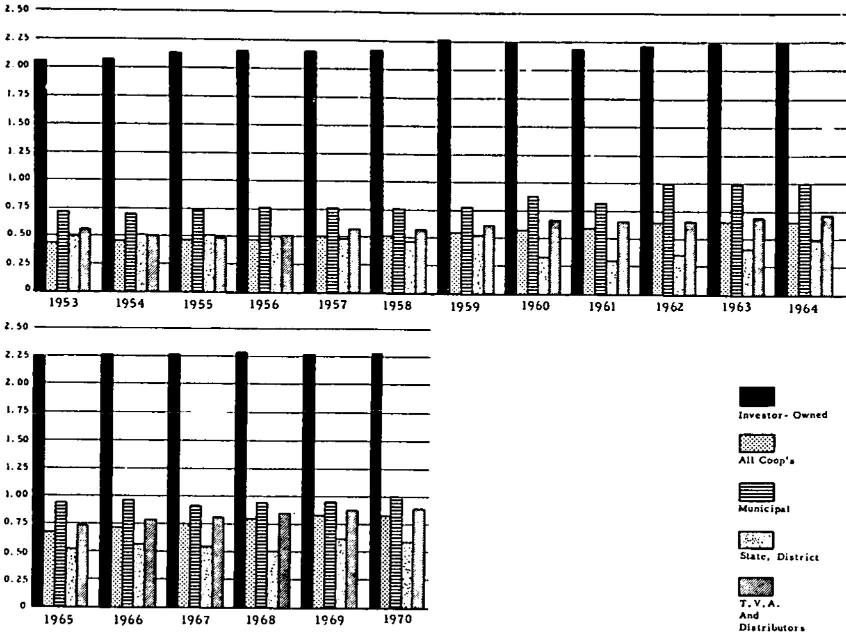
2. Amendment of Section 103 of the Internal Revenue Code to except from interest exemptions all bonds issued to acquire facilities used in the business of furnishing electric energy or in any other comparable business functions.

3. Authorization of State and local taxing authorities to impose on Federal power systems, on a nondiscriminatory basis, the same State and local taxes as are levied on comparable investor-owned systems.

4. Termination of subsidized interest rates on federal loans and repayment obligations related to power facilities.

ATTACHMENT A

TAXES OTHER THAN INCOME TAXES AS PERCENT OF ELECTRIC PLANT

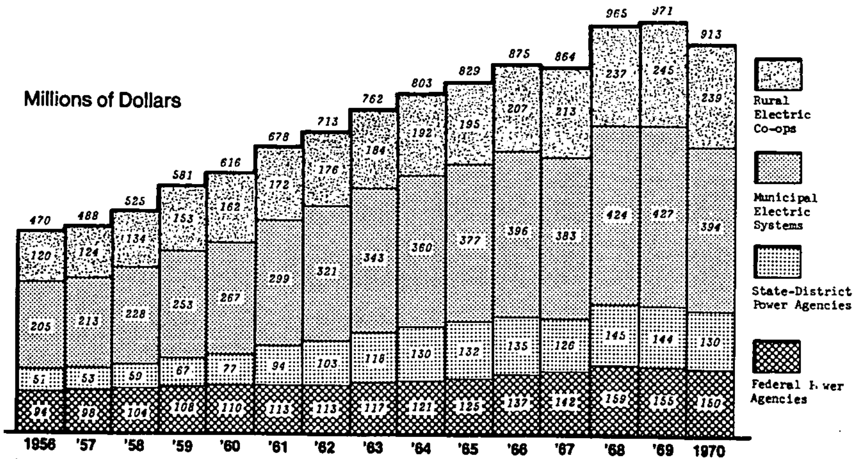


ATTACHMENT B

TREND IN ESTIMATED TAXES NOT PAID BY GOVERNMENT-OWNED AND GOVERNMENT-FINANCED ELECTRIC UTILITIES

Total Taxes Not Paid During 15 Year Period, 1956–1970=$11,053,000,000

(Based on Electric Operating Revenues*)



*Based on Ratio of Taxes Paid by Class A & B Electric Power Companies on Electric Operating Revenues

Source: Based on FPC, REA, TVA and Interior Department data.

STATEMENT OF DR. N. R. DANIELIAN, PRESIDENT, INTERNATIONAL ECONOMIC POLICY ASSOCIATION

INTRODUCTION

Tax treatment of foreign-source income has sometimes been placed in the category of "preferences," "subsidies," or "loopholes." This is an unfortunate mislabeling. The dictionary defines a "loophole" as a means of evading the intent of a statute. The current tax treatment of foreign-source income was specifically intended by the present laws for reasons of national policy, namely, to enable the United States to compete effectively in the world and encourage international trade and investment. It was reviewed extensively during the Kennedy Administration in 1961–62 and reaffirmed in its major aspects. Those who seek to change it have the burden of proof of showing that a different set of national policies should now apply, and that the gains to the national interest from change will outweigh the losses.

THE KEY ISSUES

This paper will address itself to two principal issues:[1] the tax credit now given for foreign taxes, and the so-called "deferral" of U.S. taxes until income is remitted from foreign affiliates to the parent.

The foreign tax credit has been in effect since 1918 and the United States has entered into some thirty treaties with other countries to prevent double taxation by, among other things, mutual application of credits. (See Appendix A.) The principle of tax neutrality has thus been applied *internationally*, as opposed to the relationship between domestic and international investment in a given country; it is no accident that other major industrial countries either grant credits for foreign taxes or do not tax the foreign-source income of their corporations at all.

Proposals to tax earnings currently would subject parent companies to taxes on income they have not, in fact, received or earned. As the proposed taxes would apply to a U.S. company which may have as little as 10-percent interest in a "controlled foreign corporation," the tax could be levied on earned income which may not, in fact, be available to or within reach of the American taxpayer. Such proposals would treat the income of some foreign companies in the same way as income of branches, which are legally a part of the parent, thereby, in effect, treating the separate corporate identity of foreign affiliates as a fiction, contrary to the legal systems of most advanced countries. The present code properly taxes foreign-source income only when received by the U.S. taxpayer.[2]

EFFECTS ON BUSINESS

The effects of eliminating the tax credit are shown in Table 1.

TABLE 1.—CALCULATION OF INCOME WITH AND WITHOUT TAX CREDIT

	Pretax income of subsidiary	Foreign income and with-holding tax	U.S. income tax computation	Total tax (percentage of tax rate)	Net return after taxes
Present law	$100	$45	48 percent of $100=$48. $48−$45=$3.	$45+$3=$48	$100−$48=$52.
Burke/Hartke	100	45	$100−$45=$55. 48 percent of $55=$26.	$45+$26=$71	$100−$71=$29.

Where the foreign corporate income tax rate is 45 percent, the net return after taxes of each $100 earned would drop from $52 under the present law, to $29 if the tax credit is eliminated—an increase in the tax rate of almost 50 percent.

[1] Several subsidiary issues have also bee raised: the depreciation allowance for foreign operations, tax treatment of patents and technology, and the exclusion of earned income for U.S. citizens abroad. These are not treated in this paper because of their lesser significance, nor are such special incentive features as DISC, the Western Hemisphere Trade Corporations, etc.

[2] The 1962 amendments to the Internal Revenue Code do impose taxes on undistributed earnings where there is a certain percentage of U.S. ownership to the extent that such earnings are considered tax-haven income ("Subpart F" income). The Hartke-Burke proposal would extend Subpart F treatment so as to tax U.S. corporations owning 10 percent or more of a "controlled" foreign corporation on their pro rata share of all the "controlled" corporation's current earnings.

Table 2 shows the competitive effects which the elimination of the tax credit for a U.S. subsidiary operating in the U.K. would have. The U.S. parent would have a net return after taxes of $28 compared to a range of $54–60 for German, Japanese, and British parents, respectively, from their investments in the United Kingdom.

If the effects of eliminating the tax credit are combined with current taxation of "affiliate" income which the parent has not received, the adverse effect on corporate operations would be greater. Depending on the degree to which additional income was thereby taxed which would not otherwise have been distributed and taxed, the taxes could be increased by from $160 million to $900 million from the elimination of deferral alone. Abolition of the foreign tax credit in addition, would push this figure to $3.3 billion.

American multinational companies are virtually unanimous in their view that their international operations would suffer greatly.

It is, of course, difficult even for an individual company to calculate the precise courses of action which they would follow in the event that the tax credit was eliminated and/or taxation of affiliate income was imposed when earned rather than when distributed. For each company concerned would have to revise its overall investment, marketing, and growth strategy to take account of such drastic changes in the tax laws. Given the wide variety of situations which each company would face for particular products and particular foreign markets, it is difficult to make hypothetical judgments.

TABLE 2.—COMPARISON OF AFTER TAX EARNINGS FROM COMPANY OPERATIONS IN THE UNITED KINGDOM

	U.S. parent company				
	Present	With Hartke-Burke	German parent company	Japanese parent company	United Kingdom company
United Kingdom earnings before tax	100	100	100	100	100
United Kingdom corporate income tax	40	40	40	40	40
Net after United Kingdom corporate tax	60	60	60	60	60
Distribution (70 percent) [1]	42	42	42	42	
United Kingdom withholding on dividend [2]	6	6	6	4	(3)
Total United Kingdom tax	46	46	46	44	40
Home country tax on parent company		26		(4)	(3)
Total tax	46	72	46	44	40
Net after tax	54	28	54	56	60

[1] A 70 percent distribution percentage was assumed.
[2] United States and German withholding based on 15-percent rate; Japanese on 10-percent rate pursuant to United Kingdom-Japanese bilateral agreement.
[3] Not available.
[4] An average corporate tax rate of 45 percent was assumed.

Table 2 shows the after-tax earnings of a U.S. corporate shareholder on the profits derived from the operations of a subsidiary in the U.K. and the effect the enactment of the Hartke-Burke tax provisions would have on those earnings. A comparison is also made with German and Japanese corporate shareholders having subsidiary companies in the U.K. as well as with a local U.K. company.

NATIONAL INTEREST

The effects of such tax changes on particular companies are, of course, a matter of great importance to them, to their employees and stockholders, and to their communities—which gives the question a political as well as an economic significance. But it can be argued that the harm caused to individual companies is not necessarily the ultimate criterion—any more than are the criteria of "equity" or "neutrality" which are featured in the arguments of tax reformers. Rather the governing criterion must be the effects on the United States' economy as a whole and the competitiveness of American business in the world economy. And, as noted earlier, the burden of proof must on those seeking to make drastic changes in a well-established taxation system to show that the national economy will be benefited more than it is harmed.

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Estimating the aggregate effects of tax changes multiplies many times the difficulty of forecasting what an individual company would choose to do under certain conditions 2 to 5 years away. Nevertheless, I believe that Congress should insist that such answers and estimates as are obtainable be prepared and thoroughly studied before legislative changes of such magnitude are considered.

Unanswered Questions About the Effects of Change

Some of the major questions requiring answers are enumerated below.

1. *What are the likely net effects on U.S. Treasury revenues?*

Both the Commerce Department and one of the witnesses before this Committee, a longstanding critic of the present system,[3] are in apparent agreement that the cost to corporation in additional taxes or the U.S. revenue "gain," other things being equal, would be on the order of $3.3 billion if the tax credit were applied to foreign income when earned and the tax credit were replaced by an expense deduction. The corporate loss (or revenue gain) would be much smaller (in the range of $160 million to $900 million) if the tax credit were retained but income were taxed when earned.

These estimates, however, assume that the corporations affected would continue their present business pattern in all of their overseas operations unchanged, notwithstanding the substantial reduction in after-tax earnings. This would clearly not be the case, and a more accurate estimate must take account of the likely effect on business decisions. Therefore, the assumption that the Treasury would gain $3.3 billion in new revenues with these two tax revisions is not sustainable.

2. *What would be the effect on new direct foreign investment by American companies?*

Here one would have to assume that there would be very little new or additive foreign direct investment, since an investment which earned 10 percent on its book value in, let us say, the United Kingdom which amounts now to 5.4 percent after tax, would be reduced to 2.8 percent by the elimination of the tax credit, as shown in Table 2. Given the risks and uncertainties of foreign operations, few companies would hazard additional capital at a rate of return far below what they could achieve in the tax-exempt securities market at home. There would be some exceptions, of course, where an investment was critical in maintaining access to a foreign market, a competitive position for certain exports, or access to vital raw material or fuel resources. Reinvestment of earnings, borrowing in foreign capital markets, or transfers of capital from the United States for such small returns would not be at all attractive. To the extent that this is the primary motivation of the proponents of such punitive taxation, they would probably succeed. Whether this would be to the advantage of the United States as a nation is another question which must be answered.

3. *What would be the disposition of present U.S. investments abroad?*

These had a 1971 book value of $120 billion of which $80 billion was direct investment. Companies would face a variety of options; some would retain their investment for market or raw material access reasons or because of lack of alternative opportunities. Many, however, would undoubtedly seek to reduce their investments over a period of time, with the liquidation necessarily taking place in a "buyer's market." A few might enter into joint ventures and seek to supply management and technical services to the former affiliate. Still other companies might succumb to the temptation of transfering as much as possible of their present foreign investment—perhaps some of their domestic investments as well—entirely outside the tax jurisdiction of the United States. This would mean establishing their corporate headquarters, for example, in Switzerland, and treating the firm's *American* operations as a foreign subsidiary. How successful such efforts would be, given the probable attempts to impose transfer taxes and other impediments, can only be speculated. It does seem inevitable, however, that there would be a substantial reduction in the present taxable foreign investment base and income outside the United States.

4. *What uses would companies repatriating their foreign investments make of the capital?*

This is of course a critical question; some organized labor spokesmen and tax reformers appear to believe that much, if not all, of such repatriated capital

[3] Mrs. Peggy B. Musgrave, Associate Professor of Economics, Northeastern University, Statement of July 21, 1972 to JEC.

would be put to work in the United States in productive enterprises thereby increasing U.S. employment and exports. This assumption is open to serious doubts.

In the first place, the primary motivation leading to the upsurge in foreign investment was a lack of comparable investment and market opportunities in the United States rather than a shortage of capital. The U.S. economy has been operating at well under full capacity and I know of no data suggesting that greater availability of investment capital would significantly increase U.S. production.

Some companies, of course, could increase their domestic production in some lines for both foreign and U.S. consumption; others would invest in entirely new projects; while others would seek domestic acquisitions in order to diversify. (This, of course, would increase the number of vertical and horizontal integrations and concentrations of industries, with some significant side effects. The anti-conglomerate and anti-bigness campaign in some quarters, for instance, is in conflict with the proposition that the multinational companies, if prevented from investing their funds abroad, would invest them at home, thereby becoming bigger!)

Other companies would invest their capital in securities would would not, directly at least, increase domestic employment. The after-tax rate of return would almost certainly be below present levels. Still other firms might choose to retire preferred stock or corporate debts, thereby reducing their debt-to-equity ratio and their debt service obligations.[4]

It is almost impossible to estimate the aggregate net effects of hundreds of such corporate decisions. What does seem virtually certain, even though no numerical values can be assigned, is that the total earnings of America's best international competitors, which are its multinational firms, would be substantially reduced. This would make the expected $3 billion-plus revenue gain to the Treasury illusory. Over a period of time, it is not inconceivable that the indirect effects; e.g., reductions in revenues from individual income and capital gains taxes, would more than offset any revenue gain from increased corporate taxes. This must remain speculation in the absence of quantifiable assumptions.

5. *What would be the effect on the U.S. balance of payments?*

One figure which is indisputable is that earnings from direct foreign investments, including royalties and fees, have been growing from $2.9 billion in 1960 to $9.3 billion in 1970. This return, which is the only large breadwinner in the current balance of payments, substantially exceeds the capital outflows. It created a net surplus in this account of $4.7 billion in 1971. There is every prospect that these earnings can grow substantially so as to reduce the U.S. balance of payments deficit if we can resist the masochistic compulsion to kill the goose (foreign investment) which lays the golden eggs (investment income).

Foreign direct investments in the United States also continue to grow, although from a much smaller base, and we must pay increasingly large amounts to foreigners on their investments in the United States. If by unwise actions the U.S. Government causes a substantial diminution in U.S. earnings abroad so that outflows to foreign investors might, in time, catch up to the income we receive from foreign investments, then we will have lost this one sure source of net income in our international accounts.

There is a remote possibility that some truly multinational corporations may choose the option of incorporating abroad. The U.S. Government would then lose all right to tax them on their foreign earnings. In addition, earnings from American operations would be repatriated to a new *foreign* headquarters, thus generating a further outflow of funds from the United States, aggravating our balance of payments deficits.

6. *What would be the effect on the U.S. balance of trade and related employment?*

This is one of the most critical questions and the one on which the advocates of eliminating the foreign tax credit have the least evidence to support their case. It is a fact that exports to American affiliates abroad now account for about one-quarter of all U.S. exports. The critical question is what percentage of these

[4] Many companies have borrowed abroad to invest there, rather than use the limited amount of capital which the Office of Foreign Direct Investment (OFDI) controls allow to be transferred overseas. Few investors would maintain debt structures abroad in order to invest in the United States; and most firms would probably pay off their overseas debts with the receipts from liquidations.

exports is dependent upon the affiliation, or might take place if the affiliation were severed as the foreign subsidiaries' operations became only marginally profitable after taxes. Professor Peggy B. Musgrave [5] states that "empirical evidence, although not conclusive, suggests that any positive effects on net exports arising from foreign investments are not large." Casuality is, of course, difficult to prove in any case; but a recent study by Professor Robert G. Hawkins [6] of New York University has estimated on the basis of rough assumptions that nearly half of the exports to affiliates might be dependent on the affiliation. Many business organizations would argue that most if not all of the exports to affiliates are "tied," and that even some exports to nonaffiliates are due to market access and product identification established through foreign investment. The point is, however, that no hard empirical facts are available. One would have to make an industry-by-industry and company-by-company study of markets, costs, and prices to find out how much of the exports are induced by company affiliation and international integration and standardization of production machinery, production process, and product. But even if half of the exports related to overseas affiliates might be jeopardized by disinvestment, there would be a potential loss of U.S. exports amounting to $5 billion or more annually.

It is also sometimes alleged that the American multinational corporations produce abroad in low-wage and low-tax areas and then import into the U.S. market. While this may be true in a very limited number of cases, aggregate statistics simply do not bear out this allegation. Of the roughly $60 billion in overseas production by American manufacturing affiliates in 1968 (the last year for which figures are available) only 8 percent was imported back to the United States, with the remainder going to the country of production or third countries; and if Canada is eliminated (as a special case due to the U.S.-Canadian automotive agreement) less than $1 billion was imported into the United States in that year from other countries! Even this small amount of re-exports to the United States may not be stopped by disinvestment of U.S. overseas affiliates, since their share of the U.S. market would, in most cases, be picked up by foreign competitors. Thus, there would seem to be little, if any, reduction in imports attributable to revising the tax system.

With regard to the question of displacement of potential U.S. exports by foreign manufacturing affiliates, there are relatively few actual cases of such displacement. Studies by many business organizations and detailed case studies by the Harvard Business School [7] show that decisions to invest abroad were necessitated by such factors as foreign tariff and nontariff barriers, market considerations, including local consumer preferences, local sourcing requirements, transportation and perishability factors, as well as lower costs of production. The implication is that little, if any, of the foreign production could have been carried out on economically viable terms in the United States.

On balance, therefore, it seems likely that the overall effects on the trade balance would be negative, although it is not currently possible to give a precise estimate of the amounts, except on the basis of case studies.[8]

7. *What would be the effects on the business sector of the economy and the stock market?*

If one takes the figure of $3.3 billion in potential additional taxation and revenue to the U.S. Treasury, and applies it to the foreign-source earnings of American corporations, the reductions in the earnings of America's largest corporations would be significant.[9] This reduction in actual earnings and future

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[5] Joint Economic Committee compendium on "The Economics of Federal Subsidy Programs," Part II—International Subsidies, June 1972, page 213.

[6] See Robert G. Hawkins, *Job Displacement and the Multinational Firm: A Methodological Review*, Center for Multinational Studies, Occasional Paper No. 3, June 1972.

[7] Robert Stobaugh and Associates, "U.S. Multinational Enterprises and the U.S. Economy," Harvard Business School, 1971.

[8] The Akron, Ohio Chamber of Commerce recently surveyed 17 multinational companies operating in its area and concluded that enactment of the Hartke-Burke bill in its entirety would eliminate 10 percent of their combined work force or 6,500 jobs in the Akron area. The study indicated that the resulting loss of manufacturing payrolls in the community would eventually cause a further reduction of an additional 6,500 jobs in the nonmanufacturing and service sectors. See the *Akron Beacon Journal* of June 4, 1972.

[9] There is no currrent and comprehensive breakdown available of the proportion of foreign operations in the total sales of U.S. industry. One 1968 study, based on 1965 data, found that of the *Fortune* 500, one-quarter had 25 to 50 percent and two-fifths had 10 to 24 percent (Bruck and Lees, "Foreign Investment Capital Controls and the Balance of Payments," New York University Institute of Finance *Bulletin*, No. 48–49, April 1968, Table II.) These proportions have undoubtedly increased since 1965. Applying 1971

earnings potential might cause a drop in the stock market. Obviously this effect is difficult to estimate quantitatively owing to the numerous factors determining market values at any given time, as well as the varying degrees of impact on companies with different proportions of aggregate income received from abroad. While one can say with certainty, however, that if a company that received 50 percent of its net income from foreign operations has its taxes raised by 50 percent, it will suffer a 25 percent reduction in its after-tax income. Such drastic surgery cannot but have adverse effects on equity values, no matter what the prevailing earnings/price ratio. Consequences to collateral loans, and to mutual funds and pension funds holding that security would be drastic. The equity value of each company's stock would be affected proportionately to the importance of the foreign earnings to the total. While one cannot estimate the magnitude of the "ripple" effects, the consequences would appear to be serious enough to warant the most careful inquiry before Congress is asked to take fundamental decisions about the tax structure.

8. What would be the effects on the long-term competitiveness of the American economy?

During the past decade both the U.S. and the world economies have been growing; and in some cases foreign markets have been expanding faster than those at home. Production by American firms both at home and abroad has expanded to fill these markets; but there is no evidence that the industries with the heaviest foreign direct investment have suffered in their domestic output or growth as a result. Indeed, the relative comparisons suggest the reverse.[10] If, however, the imposition of double taxation should lead many companies to withdraw from foreign markets, their place would soon be taken by competitors.

It is also important to recall that American industry increasingly depends on foreign sources for vital raw materials and that the economy as a whole consumes more energy resources and minerals than can be produced domestically. A recent report of the Secretary of the Interior suggests that by 2000 this shortfall may be in the magnitude of $64 billion[11] annually which if procured abroad would place a potential burden on the U.S. balance of payments which must be offset by foreign-source earnings. Moreover, some of the foreign affiliates which would be affected by the tax changes play an important role in securing access to energy and raw material resources at lower costs than might otherwise be the case.[12]

The important point is that we cannot "keep American industry at home." The United States cannot live in an isolated, autarchic, mercantilist system of economic organization. We need to import many products. We cannot find ways of paying for them. Exports are one means of payments, but not enough. We must rely to an increasing degree on investment income. This we must encourage, rather than discourage.

CONCLUSIONS

It is being suggested by some members of Congress as well as witnesses before its committees that the entire basis of multinational taxation be changed. The ramifications are far-reaching—more so, in certain respects, than proposals to revise and restructure domestic taxation. In a search for equity and tax "neutrality" at home, it is proposed that decades of effort devoted to developing treaties, conventions, and national tax systems which will be equitable *internationally* and thus promote international trade and investment should now be reversed. Some thirty treaties are involved. The United States is by no means alone in having a national tax policy which gives a special status to foreign-source income. Most major industrial countries grant tax credits to avoid double taxation—and some do not tax it at all, in order to maintain their competitive

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sales to 1965's top ten multinationals (over 50 percent of sales from foreign operations), these ten companies alone would lose nearly half a billion dollars, or roughly one-fourth of their after-tax earnings if the foreign tax credit were removed. There would presumably be commensurate reductions in the values of their stocks.

[10] Robert G. Hawkins, *U.S. Multinational Investment in Manufacturing and Domestic Economic Performance,* Center for Multinational Studies, Occasional Paper No. 1, February 1972.

[11] "First Annual Report of the Secretary of the Interior under the Mining and Minerals Policy Act of 1970 (P.L. 91–631)."

[12] The "branch" form of foreign investment is used principally by the banking and extractive industries, due to legal requirements. Their overseas income is already taxed when earned, since it is legally income of the U.S. taxpayer. But branches in the extractive industries would be adversely affected by the elimination of the tax credit.

position in the world. The point is that establishing "equality" or "neutrality" between U.S. domestic and U.S. foreign investment income automatically establishes *inequality* for U.S. firms as against foreign competitors! To avoid this result would require complete revisions, and indeed reversals, of the whole system of international tax conventions!

The proposal to tax foreign-source income when earned would extend the U.S. tax jurisdiction to the income from certain foreign investments made by U.S. taxpayers who might lack control over the disposition of that income and to which they might have no claim! At a time when the U.S. Government and a large body of Congressional opinion is straining to convince the world that we stand for non-interference in the internal affairs of other countries, we should be doubly cautious that we do not extend the extra-territorial authority of our tax laws under the guise of tax reform.

Such drastic changes would seem to require that a very clear case be established that the national interest would be helped more than it would be harmed. Yet there are at least eight questions, enumerated in my statement, about the effects of such proposals to which clear answers are lacking. Such data as there are, applied to reasonable assumptions about the actions which might have to be taken by U.S. corporations with substantial overseas activities, suggest that the benefits might well prove illusory in the long run, while the negative impact could be substantial. There is scant evidence to justify such far-reaching changes in the taxation of foreign-source income.

One last philosophical note. It is common currency in political rhetoric that the world now possesses the technical knowledge to solve the problems of poverty, health, education, housing, and environmental protection. If so, it cannot be denied that the world also needs capital, human resources, and efficient organization to tackle this monumental job.

There are three major forms of organizations around the world vying for supremacy, each promising that it can do the job better than the others: Statism (national socialism or communism), nation-state enterprises (private or mixed), and multinational companies, mostly private. The first sacrifices individual freedom and has proved inefficient. The second is ill-adapted to the proper exploitation of modern technology, and in the past has led to many wars. The multinational corporation under appropriate regulation, is a new and the most promising vehicle to organize capital, management and technology to undertake this gigantic task of production and distribution. It is to the twentieth and twenty-first century world economy what the limited liability corporation was to the economy of the eighteenth and nineteenth century nation states. One need not admire everything that is done in the name of private enterprise to perceive that here is a most useful instrumentality which is efficient in the use of resources; it commands technical knowhow, it is mobile across national boundaries; and above all, it is most consistent with the preservation of personal choice and individual freedom.

Those who are making a profession of attacking the multinational corporation, aiming to dismember it, through taxation and other means, have the burden of proof that statism or national enterprises of the nineteenth century variety are better qualified to rise to the challenge of human aspirations. For if the critics of the MNC's succeed, the most likely successors will be one of the other less attractive alternatives in the organization of the national and international economy.

Appendix A

U.S. Double Taxation Treaties on Income Taxes In Force January 1, 1972

1. Australia, 1953
2. Austria, 1957
3. Belgium, 1953
4. Canada, 1942
5. Denmark, 1948
6. Finland, 1952
7. France, 1949
8. Federal Republic of Germany, 1954
9. Greece, 1953
10. Ireland, 1951
11. Italy, 1956
12. Japan, 1953
13. Luxembourg, 1946
14. Netherlands, 1948
15. New Zealand, 1951
16. Norway, 1951
17. Pakistan, 1957
18. South Africa, 1952
19. Sweden, 1939
20. Switzerland, 1951
21. Trinidad & Tobago, 1970
22. United Kingdom, 1946

The following treaties are in force through extension of the operation of the treaties indicated to newly independent countries:

U.S.–U.K. Treaty, 1946:

23. Barbados
24. Gambia
25. Jamaica
26. Malawi (formerly Nyasaland)
27. Nigeria
28. Sierra Leone
29. Zambia (formerly Northern Rhodesia

U.S.–Belgium Treaty, 1953:

30. Burundi (formerly Urundi)
31. Rwanda (formerly Ruanda)
32. Zaire (formerly Belgian Congo)

NATIONAL ASSOCIATION OF MANUFACTURERS,
GOVERNMENT FINANCE DEPARTMENT,
July 24, 1972.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee,
New Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The NAM shares your concern over the lack of careful analysis in the current tax reform debate. The country has been bombarded with demands for massive changes in the Code with scant, if any, attention to the actual tax policy record to date.

Even more important, before we start tearing the Code apart, we should have a much better idea of what objectives this will serve. Much of this year's "debate" has been couched in terms of income distribution, tax equity, raising large amounts of additional revenue, and granting relief from existing taxes. To say the least, pursuing these purposes simultaneously could hardly provide a consistent framework for reform considerations.

The NAM believes that some changes in federal taxation would be highly desirable. We intend to make detailed legislative proposals when the tax-writing committees take up the issues next year. For the purpose of the current Joint Economic Committee hearings, we would like to make a background recommendation and offer some comments on the studies that your Committee has published and is undertaking. We would appreciate it if you would make this letter part of the record of these hearings.

Basic Approach to Tax Reform.—Our view of tax reform is to provide a better climate for productive enterprise of all income groups. We believe that both tax equity and economic progress can best be served when tax rates are moderate at all points.

In this country we have high rates of income taxation, both individual and corporate, although these rates have been reduced somewhat over the past decade. Most of the so-called tax "preferences" now under attack were designed specifically to relieve the burden of high marginal rates on some activity which Congress deemed particularly worthy of encouraging. Obviously, the lower the rate structure, the less need for these special provisions.

In the 1964 Tax Reduction Act, Congress made a commitment to encourage the real growth and vitality of the private sector and to hold down government absorption of resources through the progressive income tax structure. We think this was a wise decision, in light of the subsequent record. Although budget considerations appear to rule out a general income tax reduction in the early 1970's, it still would serve a very useful purpose to renew the commitment to moderation in the rate structure—even to set a schedule of future across-the-board tax reductions.

In our view, a program of across-the-board tax reductions can only be made effective through much better control of government spending, an ambitious but essential task which we believe the Joint Economic Committee fully recognizes. We doubt very much that the leeway for any significant rate reduction could be provided by plugging loopholes, equity considerations aside.

In the meantime, the need remains for many provisions in the Code to relieve the burden of high marginal rates on the critical areas, particularly those pertaining to capital formation and productive investment. This, of course, is the reason for the investment credit, ADR, the DISC tax regime, lower rates of capital gains taxation. We believe tax policy should encourage job-creating, private sector investment, and indeed, should go further in such encouragement. How

else are we going to continue to pay wage scales so far above everyone else in the industrialized world?

One of the specific measures we will present to Congress next year is to *expand* the ADR program to make it a more authentic and more liberal cost allowance system. This serves the same basic economic objective as the investment credit—to stimulate job creation and real per capita income gains through productivity advance. It should be noted that even with the tax changes under the Revenue Act of 1971, we are still behind most of our industrialized foreign competitors in the tax treatment of capital recovery.

Joint Economic Committee Studies.—In announcing the current hearings, you indicated a focus on some issues on which Congress needs better information, specifically:

Income classes primarily benefitting from the special provisions now in the tax law.

The extent to which these special provisions achieve specific goals that are valuable to the general society.

The extent to which reform should focus on corporate vs. individual income taxes.

Aggregate estimates of the revenue that can be saved through tax reform.

Whether tax reform is a good way to redistribute income.

The economic effects of any major income redistributions by reason of tax reform.

This is a good working list of questions that we hope the Joint Economic Committee will delve into in depth over the coming months. We believe that the best answers will not be found in the heat of the Presidential campaign, but through painstaking analysis that is the hallmark of your Committee's deliberations.

In your consideration of these questions, we urge you to:

1. Consider the extent to which income classes benefit from government transfer *payment programs* as well as special tax provisions. Census studies have indicated a much more progressive overall tax structure when the impact of government spending is included in the calculation. This should be even more pronounced with the recent changes in Social Security legislation.

2. Consider an objective analysis of what *has been done* with regard to corporate vs. individual income taxation. From recent politically-oriented statements it would appear that the corporate sector is getting off virtually scot-free. Treasury data, on the other hand, show that over the last four years the effect of major legislative changes has been to *increase* corporate tax burdens, while individual income taxes have been significantly reduced, particularly for lower-income groups.

3. If new aggregate estimates are to be made of additional revenue that could be gained through eliminating tax preferences, some more realistic methods of dealing with "feedback" effects should be employed. As you know, simply adding up the numbers has spread a picture of huge potential tax savings which is quite illusory. Attention should be paid to the adverse revenue effect from a slower general economy if some investment incentives were eliminated, the cost of government subsidies where they would be likely to be substituted for tax provisions, and the necessity to phase in very gradually eliminations of, or restrictions on, provisions that had applied over a period of years, where values had been capitalized long beforehand.

We strongly suspect that the result of such a calculation, difficult as it may be to derive, would be a substantial deflation of potential tax "savings."

4. We urge you to give particular attention to the social and economic implications of any forced large-scale income or wealth redistribution through the tax system. We have the feeling that many tax reformers look at wealth as a static distribution rather than as a dynamic process of production. We believe the latter constitutes the real wealth of any country, and it behooves us to assess very carefully what would happen to incentives to work, produce and invest if some of the income redistribution proposals were taken seriously. We should make this thorough assessment well before embarking on any attempt to overturn the tax code.

Very truly yours,

MELVIN C. HOLM,
Chairman, Taxation Committee.

FOREST INDUSTRIES COMMITTEE ON TIMBER VALUATION AND TAXATION,
Washington, D.C., August 8, 1972.

Hon. WILLIAM PROXMIRE,
Chairman, Joint Economic Committee,
New Senate Office Building, Washington, D.C.

DEAR SENATOR PROXMIRE: Among the papers released by you in connection with the Committee's recent hearings on tax reform was a paper authored by Emil M. Sunley, Jr.,[1] entitled "The Federal Tax Subsidy of the Timber Industry".

In view of the recommendations contained in Mr. Sunley's paper, the *Forest Industries Committee on Timber Valuation and Taxation* requests that the following comments appear in the record so that readers will receive a more balanced picture of the application and effect of the Internal Revenue Code provisions relating to the taxation of timber proceeds.

Submission of these comments is in pursuance of the objective of the Forest Industries Committee of attempting to secure the widest understanding of the tax rules applicable to timber. The Committee includes among its correspondents on timber tax matters over 40,000 timber owners and is supported through voluntary contributions of both large and small tax payers from virtually every state in the Union who are part of the forest economy and thus affected by timber capital gains taxation.

In 1943, Congress enacted a provision in the Revenue Code which was designed to encourage and permit private timber owners to manage their lands for continuous production of timber in order to meet the nation's ever-increasing needs for wood and fiber.

Congress has periodically reviewed the progress of private forestry since enactment of the 1943 tax provision, and in each instance has reaffirmed this important incentive to timber investment and conservation.

In 1963 and 1969, the House Ways and Means Committee received over 1,700 pages of testimony from forest economists, public officials, small and large timber owners, professional foresters and others fully analyzing the economic considerations underlying the tax rules applicable to timber, and overwhelmingly supporting their continuation.

In view of its size, no attempt will be made here to summarize the record of the 1963 and 1969 Hearings. However, since the recommendations contained in Mr. Sunley's paper are based on what he contends is the lack of evidence that the 1943 tax provision has been an effective incentive, we are attaching some excerpts from the record dealing with that matter. It should be noted that two of these excerpts contain statements of the U.S. Forest Service indicating the beneficial effect the 1943 tax provision has had on forestry investments and timber supply.

It is further argued by Mr. Sunley that "direct" subsidies could be substituted for timber capital gains taxation as a means of meeting the nation's forest conservation and timber supply goals, and it is implied that such subsidies would be less costly to the government—although no specific proposals are suggested. In the past, several direct subsidy proposals have been put forth by forest economists which would supplement the beneficial effects of timber capital gains taxation on conservation and timber supply. Without expressing any judgment on the need for such programs, it is relevant in the context of Mr. Sunley's paper to point out that these proposals have generally been costly in terms of revenue; and often have cost more than the timber capital gains provisions here proposed to be repealed.

We urge members of the Joint Economic Committee, other public officials, and private citizens concerned about the nation's forests and our burgeoning timber supply requirements to read the attached excerpts and other relevant testimony in the record of the 1963 and 1969 Hearings. We are certain that after having done so, they will better understand both the economics of timber investment and why alteration of the present tax rules applicable to timber would seriously affect the ability of private timber owners to meet the rising demand for wood products and depress the economies of the thousands of communities dependent on a healthy timber industry.

Sincerely,

WILLIAM K. CONDRELL,
General Counsel.

[1] Economist, Office of Tax Analysis, U.S. Treasury Department. The author points out that the views expressed are his alone and are not those of the Treasury Department.

EXCERPTS FROM TESTIMONY BEFORE HOUSE WAYS AND MEANS COMMITTEE IN 1963 AND 1969 RELATING TO EFFECTIVENESS OF INCENTIVE PROVIDED BY PRESENT TAX RULES APPLICABLE TO TIMBER REVENUES

1963 HEARINGS

Testimony of Mr. Paul M. Dunn, President, Society of American Foresters:

"Classifications established in the Revenue Act of 1943, in essence, permitted capital gains treatment of revenues resulting from long-term increases in timber growth and value, regardless of the method used in disposing of timber. This action removed a major tax barrier to investment in forestry. . . . It was of fundamental importance in releasing the flow of investment into private forestry which has occurred during the postwar period. The major improvement in the Nation's timber supplies, the large-scale investment in wood-processing facilities with related permanent employment in many rural areas, and the watershed and recreational benefits derived from forest management which have been achieved on private lands during the last 20 years are directly traceable to this classification of timber revenues." (Tr. 3344).

Testimony of Senator Len B. Jordan of Idaho:

"As late as 1958, the U.S. Forest Service, in its report No. 14, entitled, 'Timber Resources for America's Future', pointed out the importance of the 1944 timber capital gains tax to good forestry practices. They said: 'Financial factors are also playing a part in the development of industrial forestry. Capital gains . . . (effective in 1944) of the Internal Revenue Code have made timber growing more attractive and have provided incentive for more aggressive forestry programs.'" (Tr. 2932).

Testimony of Dr. Wilson Compton, American Forestry Association of Washington, D.C.:

"[T]he American Forestry Association as an organization is simply a citizens' organization of persons who are conservation minded. . . . The (following) resolution was the action of the board of directors . . . by unanimous vote: 'The inclusion of gains in timber growth and value as eligible to taxation as long-term capital gains has been the largest single factor responsible for the vast nationwide progress, during the past quarter century, in timber and water conservation, in sustained-yield management of privately owned forests, in the development of recreational facilities, and in the maintenance of permanent sources of employment in forest-dependent communities.'"

Testimony of Representative Arnold Olsen of Montana:

"Many of the firms in the lumber industry of my district and State could not afford to continue to manage their acres of forest lands if the incentives provided for in section 631 are removed. . . . Repealing of section 631, as proposed, would force the industry to return to the wasteful forestry methods used 20 or 30 years ago." (Tr. 2942).

Interim Report of Stanford Research Institute:

"Had the Revenue Act of 1944 not broadened the availability of capital gains treatment of timber, the forest liquidation climate would have extended into the future and would have continued to severely affect local economic stability, the productivity of the nation's forests, and the level of new investment and employment in the nation's forest product industries. The growth in forest protection and management on the nation's industrial forests that has occurred since 1944 would not have been as great." (Tr. 3093).

Testimony of Mr. M. H. Collet, President of Olinkraft, Inc.:

"In the 10 year period through 1968, forest industry owners planted and seeded an average of 502,000 acres annually, increasing from 417,000 acres in 1959 to 604,000 acres in 1968. . . . These accomplishments are compelling evidence of the effectiveness of the incentives for reforestation provided by Section 631. The contribution of Section 631 to this remarkable performance by the forest industry has been recognized by the Forest Service. 'Beyond the influence of any income tax upon timber management are the specific effects of the Federal tax, with its provisions regarding the treatment of long-term capital gains. One of these effects is to encourage the forest owner to incur silvicultural expenses that may be charged against his ordinary income. Another is to stimulate forestry investments in general because of the favorable treatment their revenues from timber will receive. The result is to favor an increase in the timber output of private forest owners, particularly in the long run. . . . It is assumed for purposes of this analysis that the features of the Internal Revenue Code will be retained.' (Timber Trends in Western Oregon and Western Washington, U.S.F.S. Research Paper PNW 5, 1963, p. 46." (Tr. 2827–28).

Final Report of Stanford Research Institute:

"The current federal tax policy with respect to timber has made a substantial contribution to extending the nation's timber supplies. It has accomplished this by permitting the owners of large private forests to justify financially better protection and management practices on their forests and to manage them for continuous production of timber." (Tr. 2916).

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"The existing tax policy with respect to timber has also served to extend the nation's timber supplies by inducing a more orderly cutting of the old-growth forests in the West. It helped bring the public and some private overmature forests in the West into production at an earlier date. It moderated the tendency for inefficient small sawmills to liquidate fast growing young trees along with overmature timber. There have been great strides taken over the post-World War II period in fuller utilization of the timber removed from the nation's forests. The existing tax policy with respect to timber has played an important role in this development." (Tr. 2917).