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**THE ECONOMICS OF FEDERAL SUBSIDY PROGRAMS**

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**HEARINGS**  
**BEFORE THE**  
**SUBCOMMITTEE ON**  
**PRIORITIES AND ECONOMY IN GOVERNMENT**  
**OF THE**  
**JOINT ECONOMIC COMMITTEE**  
**CONGRESS OF THE UNITED STATES**  
**NINETY-SECOND CONGRESS**  
**FIRST SESSION**

—  
JANUARY 13, 14, AND 17, 1972  
—

Printed for the use of the Joint Economic Committee



U.S. GOVERNMENT PRINTING OFFICE

73-497

WASHINGTON : 1972

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Washington, D.C. 20402 - Price \$1.

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# THE ECONOMICS OF FEDERAL SUBSIDY PROGRAMS

THURSDAY, JANUARY 13, 1972

CONGRESS OF THE UNITED STATES,  
SUBCOMMITTEE ON PRIORITIES AND  
ECONOMY IN GOVERNMENT OF THE  
JOINT ECONOMIC COMMITTEE,  
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 10 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire and Representative Blackburn.

Also present: John R. Stark, executive director; Lucy A. Falcone and Jerry J. Jasinowski, research economists; and Walter B. Laessig and Leslie J. Bander, economists for the minority.

## OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. Today the subcommittee begins hearings in one of the most complicated, controversial, and neglected areas of Government activity—the Federal subsidy system. We do so for many many reasons, some of which were identified in a Joint Economic Committee staff study released earlier this week.

First, Federal subsidies constitute an incredibly pervasive set of economic influences on the private economy. We now grant subsidies to build and operate commercial ships, to develop private fish ponds and irrigation systems, to fly both commercial and private airplanes, and to provide low-cost rural electric and phone service, to name only four of the hundreds of existing subsidies. It is probably no exaggeration to say that subsidies are the dominant form of Government intervention into the incentive structure of particular private markets.

Second, much of the information necessary to understand and evaluate this pervasive system is hidden from public scrutiny. This is partly because special efforts are made by subsidy proponents to give subsidies some other label, such as aid, tax incentive, loan, or simply assistance. It is also because there are so many ways that subsidies can be granted, as cash, a tax break, through credit, as a benefit-in-kind, by the purchase of goods above market price, and through the various ways that the Government regulates markets. Finally, it is because such documents of Government management such as the budget do not account for Federal subsidies. Tax subsidies are nowhere to be found in the U.S. budget, for example.

Third, this absence of information has kept the general public from knowing how much individual subsidies cost and what price tag there



is on the overall system. The staff study released earlier this week identified fiscal 1970 Federal subsidy programs with an overall budgetary cost of approximately \$63 billion. The components of that total cost are as follows: (a) Cash subsidies of approximately \$12 billion; (b) tax subsidies of approximately \$38 billion; (c) credit subsidies of approximately \$4 billion; and (d) benefit-in-kind subsidies of approximately \$9 billion.

These high costs were a surprise to me, as I think they will be to the American public.

But even these enormous costs do not represent a complete accounting of subsidies and other special benefits. The staff study used a relatively conservative definition of subsidies which, simply put, is Government financial assistance that is designed to alter particular private market prices and incentives. It excluded and labeled as welfare payments about \$5 billion of cash payments (for fiscal 1970) the Government makes for aid to dependent children, aid to the blind, and so on.

It also excluded and labeled as special benefits those goods and services the Government distributes free to a small percentage of society, such as free use of the inland canals and free medical care for merchant seamen.

Finally, the staff was unable to obtain data on the administrative costs of those subsidies included, and no estimates at all for purchase and regulatory subsidies. The staff study should therefore be viewed as only a first step in the complex task of identifying subsidies and other special benefits.

Yet even this conservative estimate of \$63 billion amounts to more than \$1,200 for every family in the Nation.

Fourth, it is not clear how well many of these subsidies fulfill the Nation's overall priorities and some, in fact, seem to work at cross purposes. In the natural resource area, some subsidies encourage the conservation of resources and others encourage their more rapid use.

Fifth, there is almost no hard economic evidence of the public benefits from most Federal subsidy programs, nor do we know what individuals get the specific monetary benefits of most subsidies. Do housing subsidies go to the rich or to the poor? Do manpower subsidies end up in the pockets of corporations or workers? Do farm subsidies benefit the average farmer or the corporate giant? Of what benefit are the international trade subsidies to the average man? The American people have a right to know who benefits from these special benefits.

Finally, there is little if any understanding of the adverse effects Government subsidies have on the private market, such as aggravating inflation. We know from our hearings earlier in the week—in fact, we had them Monday, Tuesday, and Wednesday—that the oil import quota alone causes oil prices to be more than \$1 per barrel higher than they would be otherwise, which means that the average American family pays about \$100 more in fuel prices annually.

These are some of the major deficiencies that prevent sensible management of Federal subsidies. At the present time neither the Executive nor the Congress has taken adequate steps to insure that all Federal subsidies are fully disclosed and evaluated for the American public. Nor do old subsidies even seem to be reviewed to see if purpose is still relevant and if they work efficiently and equitably. The

system of Federal subsidies is so far out of control that we may need to structure new techniques of accountability.

The purpose of these and subsequent hearings, then, is not a vendetta against public programs that now carry on or should carry the label "subsidy." A subsidy may be good or bad depending upon its purpose and how well it works. The purpose of the hearings, instead, is to acknowledge the importance of the subsidy instrument, to study it, to ascertain the costs and benefits of particular subsidies, to determine if the objective of particular subsidies still merits a public priority, and to see what might be done to bring subsidies and other special benefits under control. Fundamentally, we are interested in determining how well the subsidy system and particular subsidies serve the average citizen.

To assist the committee in understanding and evaluating this complex area of Government and private activity, we have commissioned over 40 study papers by noted experts. Our first three witnesses, and we are very honored and delighted to have three such distinguished experts in this area—Mr. Break, Mr. Shoup, and Mr. Houthakker—will be testifying on the basis of studies they have prepared for the committee and which will be published subsequent to the hearings.

Mr. Houthakker is not here. We are trying to check to see how long he will be delayed. We expected him earlier today but, of course, the weather being as bad as it is, the plane is probably held up. He left Boston, I understand, at 7 o'clock this morning so we are hopeful he will arrive shortly.

Mr. Shoup, would you like to begin?

I beg your pardon, before you begin, I would like to ask Mr. Blackburn to make a statement.

Mr. Blackburn is a Republican member of the committee and we are very delighted to have him here.

Representative BLACKBURN. I want to thank you, Mr. Chairman, for allowing me to participate. I am not on this particular subcommittee but, frankly, the whole subject matter of subsidies is becoming more and more a matter of concern to me personally. My own committee, Banking Committee in the House, is getting very heavily involved in subsidy programs for housing for low-income families as well as for the aged; and I am beginning to wonder just what kind of obligations we are creating for the American public.

I want to congratulate you on calling these hearings. I think the whole multiplicity of subsidy programs deserves a thorough airing and I might have differences on occasion on definitions of what is subsidy or what is not subsidy and we may have differences in philosophy on whether something is justified as a matter of public policy, but certainly I think it is far better in the public interest that these matters be openly discussed and whatever differences there are at least we understand what they are.

Chairman PROXMIRE. Thank you very much.

I would just like to say in introducing Mr. Shoup, he is professor emeritus of Columbia University and is recognized both domestically and internationally as one of the leading experts in the field of public finance. His academic research covers 30 years, hundreds of papers and several books. He has also had broad policy experience,

-serving as the head of the Tax Mission to Japan, as economist with the Treasury and is now serving with the United Nations; and I understand that in your new capacity you just completed a tax mission to the Middle East.

I have read many of your papers and I have been very impressed by your scholarly work.

In welcoming you Mr. Shoup, I want to thank you on behalf of the committee for the great assistance you gave in preparing the staff study. You, along with our staff, were primarily responsible for what I think is an excellent, trailblazing study.

Go right ahead, sir.

#### **STATEMENT OF CARL S. SHOUP, ECONOMIST, UNITED NATIONS**

Mr. SHOUP. Thank you, Senator Proxmire.

I should perhaps note that my statement represents only my own personal views on the subsidy problem and although I recently accepted the position of Economist with the United Nations, the present statement does not, of course, arise out of any assignment to the U.N. and no responsibility for anything said here attaches to the U.N. or its affiliated organizations. My statement today reflects conclusions that I reached during a study that the chairman referred to made last year on the economics of subsidies.

Federal subsidies are the great fiscal unknown. The Federal budget presents no comprehensive summary of subsidies. Most public finance textbooks in the United States either do not even list the word "subsidy" in their indexes or give only a page or two of reference. There has been no monograph on subsidies in the English language—there are several in German—until, recently, this report to the committee.

Chairman PROXMIRE. I don't like to interrupt you, but I think that is an incredible thing; it is an incredible thing. With all the colossal amount of work that has been done, especially in the last 20 or 30 years by scholars, the proliferation, that not one single monograph has been done studying and analyzing subsidies.

Mr. SHOUP. Yes.

Chairman PROXMIRE. That alone is an amazing revelation to me.

Mr. SHOUP. The subject has been fragmented among many studies on this or that particular subsidy but no monograph, no general or analytical monograph on subsidies in general, what they are for, and how they achieve their purpose. It is really astonishing.

Chairman PROXMIRE. One of the reasons for our problem, I am sure.

Mr. SHOUP. Yes, indeed, and this in face of the fact that, as the chairman pointed out, Federal subsidies account for tens of billions of dollars, \$60 billion or more of Federal expenditure. The Joint Economic Committee is certainly to be commended for initiating a comprehensive description, analysis, and appraisal of the Federal subsidy system as a whole.

Now what is a subsidy? It could be defined very broadly. A broad definition would include welfare payments, old age benefit payments and even free Government services; but I prefer not to use so sweeping a definition because I believe that such a definition obscures an

essential feature of a certain type of payment that I would call a subsidy. This essential feature is that through the subsidy the Government still relies on the private market, with its pricing mechanism, to distribute the Government benefit in question. The Government operates through the private market.

Two types of food distribution programs will illustrate this difference I have in mind.

Under a surplus food distribution program, the foodstuffs are distributed quite free of charge in limited amounts to eligible families. No cash at all changes hands. This is not a subsidy as I use the term. It is a welfare payment in kind.

Under a food stamp program, on the other hand, the consuming family, with a few exceptions, must pay something for its food. Its food expenditures are subsidized. The amount of these foodstuffs that a family will consume will now depend in part on the family's reaction to the lowering of the price through the food stamp program. The price is low but it is still a price, so consumption of these foodstuffs by the family is still being rationed, still being held in check, partly by the fact that the family has to pay a price, however small it may be, in order to get the food.

This type of rationing, this type of consumption checking, this price system rationing, is not present when food is distributed wholly free of charge. In that event, the rationing has to be done in some other way. It is done, in fact, completely by direct control under the surplus food distribution, by the food issuing authority. The price system plays no part in rationing. Therefore, I would not call the food surplus distribution program a subsidy; whereas I would call the food stamp program a subsidy because it utilizes still the private marketing pricing mechanism.

A subsidy is also, I believe, to be distinguished from a welfare payment. A subsidy is given because the legislator desires to induce someone to do some specific thing: for example, eat more food, or to refrain from doing some specific thing: for example, refrain from putting a certain plot of farmland into cultivation.

A welfare payment, on the other hand, is not given in order to induce the recipient to do, or not do, some specific thing. Aid to a family with dependent children illustrates this point. To be sure, the amount of this welfare payment will commonly be decreased if the mother takes a job and earns wages. But surely it is not the intent of this program to induce such mothers not to take jobs. This payment, this welfare payment, is not intended as a subsidy for not working.

The contrast with the farmer who is paid to hold land out of production is evident. The intent behind the measure is all important in classifying it as a welfare payment or as a subsidy.

A subsidy, therefore, has two main features: First, it works through the private market, by altering certain market prices. Second, the intent behind a subsidy is to induce someone to increase or decrease his purchases, or his production, or use of some particular thing or group of things.

Subsidies take many forms, since there are many ways of influencing prices. Some of these ways are so indirect that the subsidy is not apparent. For example, a reduction in income tax is granted if the taxpayer spends his money in one way rather than another, say, in oil

exploration and development rather than in erecting commercial buildings. The tax revenue lost in this manner is commonly not recorded. Yet, the reduction in tax revenue depletes the Treasury as surely as does an outright cash subsidy.

At another example, a private borrower may be granted a loan from the Government at a low rate of interest, to construct housing. The Government loses some interest it could otherwise obtain, yet such a loss has not been recorded as an expenditure.

Many subsidies are therefore not as visible as are outright Government expenditures for personnel, equipment, and material by which the Government supplies police, firefighting, public health, defense, and other services free of charge. These services, of course, do not come under the heading of subsidy, as I understand the term.

So subsidies, as we have seen, operate through the private market by changing prices in that market and that means they also change quantities exchanged, which usually change when prices change.

If the private market were already operating perfectly, there would be no case for subsidies. But private markets often do not work perfectly. The market tends to set the price on the basis of the costs and benefits as seen by the immediate parties to the transaction. Harm caused to third parties is naturally ignored, and so are benefits accruing to third parties. Indeed, this harm to, or benefits for, third parties is often quite unknown to buyers and sellers of the particular commodity or service.

A subsidy, therefore, in my view, should have its origin in some failure of some sector of the unsubsidized private market. For example, an uncontrolled farm price mechanism may function imperfectly by generating wide swings in price and output over time, moving from glut to scarcity, low prices to high. Another example is the antipollution benefits that a community can obtain from an expanded rapid transit system because that will reduce the use of automobiles. These benefits are not bought and sold on the rapid transit market. On the rapid transit market, the riders pay only to ride and not to free themselves from automobile fuel fumes.

Of course, some subsidies do, in fact, represent chiefly self-aggrandizement, but even these are usually colored by some alleged ability to correct an imperfection in the workings of the private market.

To be sure, a subsidy may be intended merely to redistribute income. Indeed, almost any subsidy will redistribute income somewhat. Some would argue, however, that the chief intent of a subsidy might well be simply redistribution of income. For example, a subsidy on foodstuffs might be intended chiefly to make low-income families better off, not to induce them to consume more food.

But if that is indeed the aim, there is a much simpler and surer way of achieving it than through a food subsidy, and that way is simply to give a straight welfare payment, a cash payment, to the needy family. Then they can buy more food or not, as they please.

Subsidizing food, or better yet a particular type of food, instead of giving a cash welfare payment, seems to me to be justified only if there is some reason for inducing the family to consume more of the subsidized food and not so much more of other things. I am, therefore, assuming that although subsidies do redistribute income, their

chief aim must be to increase or to reduce the consumption or the production of some particular good or group of goods.

From this point of view, the food stamp program, for example, is to be judged by its success in increasing the consumption of certain types of foods by low-income families, a nutritional objective. This program represents a consumer's subsidy, designed to aid consumers in the purchase of some good or service by lowering the price they have to pay. Of course, the subsidy aids producers, too, by helping move surpluses; but that, I assume, is not the chief aim of the food stamp program.

In contrast, payments to farmers under the farm program are not designed to aid consumers. The aim is instead to reduce production, reduce not increase, in order to avoid price-depressing surpluses of the kind that brought such misery to farms in the 1930's. Or, if crops turn out to be too large anyway, the aim is to keep prices to farmers up. These are producers' subsidies, not consumer subsidies; they are designed to aid farmers through the effect on the private market for farm products.

Raising the price that the producer gets and lowering the price that the consumer has to pay are not necessarily two incompatible aims. Indeed, they are the normal result of a subsidy that, in contrast to the present farm program, induces an increase in output. A subsidy drives, you might say, a wedge between the price the producer receives, including the subsidy, if it is paid directly to him, and the price the consumer pays, minus the subsidy, if it is paid directly to the consumer.

The wedge is the subsidy rate. It represents money flowing from the Government's Treasury at the cost of taxpayers. Part of this money flow benefits the producers of the subsidized commodity, and the rest of it benefits the consumers of that commodity. But the question is; Who gets the lion's share of the benefit, the producers or the consumers?

The trick of mounting a successful subsidy program is to be clear as to what the aim is, and then to ascertain whether the market conditions will allow the subsidy to achieve that end.

Suppose that a subsidy is given on a certain type of food which is thought to be especially beneficial nutritionally. Suppose that the subsidy results in a lowering of the market price, as planned, but let us also suppose that consumers prove intractable and do not increase their consumption of this food appreciably, in spite of lower prices. They use the money saved by the low price of this subsidized foodstuff to buy more of other things. Such a subsidy could scarcely be termed a success in the light of its aims.

Suppose, to vary the case a bit, that the subsidy does not even lower the price to consumers very much. This can occur if it turns out that expansion of production of this particular good is very costly or maybe almost impossible at any price. Then all that occurs is that the producers of this good get a much higher price, including the subsidy if it is paid directly to them, than before, and consumption of this good is not appreciably increased.

Evidently the intent behind a subsidy can be frustrated because the market demand or the market supply is not responsive to price changes. The supply and demand conditions of the subsidized market are all

important for the success or failure of a subsidy that is designed to increase domestic consumption or domestic production, including production for export, or in certain other cases to decrease production, as with the subsidy paid for removing farm acreage from production. These market conditions—the responsiveness of the market to changes in prices—are also important for a subsidy aimed chiefly at redistributing income, but for reasons already given I shall not go into that problem here.

A bad subsidy then, an unsuitable subsidy, is one that fails in its purpose, such as enrichment of a favored few who possess the political or economic power to bend the system to their private aims. Actually, I am inclined to conjecture that few of the existing subsidies are entirely bad, but that almost all of them contain undesirable features and should be restructured accordingly.

To give only two examples: (1) I should not like to see farm subsidies entirely eliminated, but surely the original intent behind these subsidies has become lost insofar as the subsidies are now locked into values of farmland, no matter by whom owned or when purchased; (2) how much of the housing subsidies has gone merely to push up prices of urban dwelling sites?

All the foregoing seems to me to add up to a forceful argument supporting the initiation of some kind of continuing monitoring of the entire Federal subsidy system. This monitoring could be the task of a congressional committee, or of a permanent board or commission set up by the Congress. Such a subsidy board would have the task of listing all the Federal subsidies, at least all the major ones, and with respect to each subsidy giving an answer annually to the following questions:

1. (a) What was the major intent behind the subsidy in the first instance? (b) Is this intent still accepted?

2. What were the grounds for this intent? What particular market failure was the subsidy designed to correct? Does that failure still exist in the private market?

3. Are present market conditions with respect to demand and supply of the subsidized good such that the subsidy can accomplish the aim set for it? Or are demand, or supply, so unresponsive that little is, in fact, being accomplished except to redistribute income?

4. What about the rate of the subsidy? Does it seem currently too high? Too low? To answer this question means to examine the effects of the subsidy at the margin. The subsidy viewed as a whole may be doing a good job, but we must still ask, would almost as much be accomplished with a considerably lower rate of subsidy? Or, on the contrary, would just a few points more on the subsidy rate add a great deal to the accomplishment? These are very technical economic questions, and the board or committee that I have in mind would need to be well staffed for this purpose.

5. The fifth question I would have the board answer annually is, can the form of the subsidy be improved? For example, if it is a tax subsidy, say greatly accelerated depreciation, could the desired stimulus to investment be achieved at less cost by a direct cash subsidy on investment spending? That this is no purely academic question is shown by the fact that Great Britain has moved, within a decade,

from excess depreciation to cash grant and now back to excess depreciation.

6. How can the annual cost of the subsidy best be computed or estimated, as to those subsidies that are not direct cash outlays, and how can the taxpaying public best be kept informed of the bill they are footing? This is a formidable task both of computation and education.

The annual report of such a subsidy monitoring board should make absorbing, if sometimes disturbing, reading.

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

Mr. George Break is professor of economics at the University of California at Berkeley, where he has been chairman of the department of economics since 1969. Mr. Break was first introduced to this committee in 1955 when he submitted a paper for a compendium on "Federal Tax Policy for Economic Growth and Stability." Since then, he has submitted numerous papers to the committee, and he also has, of course, a very distinguished reputation as an outstanding economist.

It is a pleasure to welcome you back before the committee, Mr. Break.

**STATEMENT OF GEORGE F. BREAK, PROFESSOR OF ECONOMICS,  
UNIVERSITY OF CALIFORNIA, BERKELEY**

Mr. BREAK. Thank you, Mr. Chairman.

It is an honor and a pleasure to be here at this important occasion. I have a short statement that I would like to read for the record and then I would like to amplify a few of the generalities in that statement, if I may.

Chairman PROXMIRE. Fine.

Mr. BREAK. Are Federal subsidies inexpensive and efficient means of inducing private business to serve the public interest or are they costly boondoggles that mainly pad private fortunes at public expense? Or are they a complex, little understood mixture of the two? By initiating an indepth study of the vast tangle of Federal subsidy programs, Chairman Proxmire of the Joint Economic Committee and his Subcommittee on Priorities and Economy in Government are performing an extremely valuable public service.

The task they are undertaking is not an easy one, partly because subsidies tend on close inspection to be elusive creatures, hard to identify, measure and evaluate, and partly because subsidy advocates have a remarkable propensity to disguise the amounts of money involved in their programs. Shedding some intensive light on this rather murky area, however, could launch the Congress into one of the most fundamental steps in the entire budgetary process, that of pinpointing those activities that the Federal Government can best perform itself and those that it should encourage either private enterprise or State and local governments to take in hand.

The importance of clarifying such issues hardly needs to be spelled out in this company. Given the dismal prospects for a significant Federal fiscal dividend in the next few years, subsidy review becomes an urgent necessity. Can Congress ask the reluctant taxpayer to shoulder new and additional taxes, as present budgetary realities strongly sug-



gest it may soon have to do, when it cannot assure him that the money he already provides is being spent efficiently on appropriate Federal functions?

Several guidelines for budgetary review of subsidy programs are suggested in the paper that I prepared for the compendium:

(1) Identify the subsidy instrument being used as precisely as possible. In many cases it will be necessary to use an interval estimate of that instrument rather than a single measure.

(2) Estimate quantitatively the effects of that instrument on the use of resources in the private sector of the economy.

(3) Evaluate the desirability of these Federal effects, given the capabilities of private enterprises and State and local governments and the extent to which they can be expected to exploit these capabilities on their own without Federal subsidization.

(4) Phase out all subsidy instruments that have either no significant effects or inappropriate ones.

(5) Evaluate all remaining subsidy instruments in relation to their efficiency in accomplishing their goals, their effectiveness as compared with alternative measures, and the importance and direction of their side effects.

The paper that I prepared tried to set subsidies in the general context of goals and instruments that the Federal Government has to carry out its purposes, and I guess if there is one concise guideline that this study suggests it is "one instrument, one goal," and pursuing that guideline, it seems to me, that subsidies should be evaluated in terms of their primary goal on the assumption that the other goals of the Federal Government are being met, or are capable of being met, by the use of other public finance instruments.

The primary goal of a subsidy, as Dr. Shoup has indicated, and I agree with this, is to induce changes in the use of resources in the private sector, changes that are desirable on social and economic efficiency grounds.

And it seems to me that the goal of high employment is not a major consideration when one is evaluating a subsidy instrument. I believe that in many cases the advocate of a subsidy will argue the case for it by stressing the increase in employment that the adoption of the program is likely to bring.

It seems to me that that is not a convincing argument for the subsidy which rather should be evaluated at high employment GNP levels for what it will accomplish in changing the allocation of resources in the direction that we would like to see them changed because of the public purpose that can be served thereby.

Second, I would recommend that careful consideration be given to aiming the subsidy instrument at the particular goal sought as precisely as possible. I would like to illustrate this with three examples: Two of them come from the recent Canadian tax reform law which was just enacted at the beginning of this year.

First of all, percentage depletion: If the aim of percentage depletion is to stimulate exploration and development by oil companies, why not make percentage depletion a percent of those expenditures on exploration and development rather than a percentage of gross receipts of the companies involved?

Second, with regard to the lower corporate tax rate for small business, instead of making this a general rate available to all sizes of businesses, the new Canadian law, which sets up a basic 50-percent corporate rate in 1972 and uses a special 25-percent rate for small business, gives that 25-percent rate on the first \$50,000 of business income but only until the corporation has accumulated \$400,000 of total retained profits.

Beyond that point it becomes subject to the basic 50-percent rate. So this is an attempt to confine this particular subsidy to small business as long as it remains small; and the definition used here is that it no longer is small once it has earned and retained profits of \$400,000. If it distributes its profits, of course, it can remain small under this definition indefinitely; but then the profits become taxable to the stockholders as dividends.

And the third example I would use is the present interest exemption on State and local securities which has been much discussed and, of course, it benefits both State and local governments by lowering the interest rates at which they can borrow and wealthy holders of these bonds who get the exemption from their individual tax liabilities.

It would be better, it seems to me, to structure that subsidy instrument as a percentage of the interest paid on State and local debt to try to give the subsidy to the State and local governments and not to high-income individuals.

Finally, I would like to take two subsidy instruments and compare them along some of the general guidelines that I have suggested a moment ago.

I would like to compare accelerated depreciation and the investment tax credit as a means of achieving the public goal of more rapid economic growth. That, I think we can agree, is an appropriate goal for the Federal Government to seek.

The first remark should be, I think, that there may well be other and better means of stimulating growth than by stimulating business investment; but I would like to assume for purposes of this example that we do wish to stimulate business investment and are thinking about which way is the better way to do it.

As far as the definition of the subsidy instrument is concerned the investment tax credit is much clearer and more precise than the accelerated depreciation. You know, in the case of the credit, that you are giving  $x$  percent of qualified business capital expenditures; you know the amount of money involved; whereas, with accelerated depreciation you don't know how accelerated it is because you have no very clear measurement of what is economic depreciation, what the actual deductions ought to be; and so the subsidy instrument is ambiguous and difficult to compute.

Second, with respect to the measurement of Federal costs, this is done automatically and directly with the tax credit. When you are using accelerated depreciation you have to estimate the Federal costs by determining economic depreciation, measuring the excess of the acceleration over that and then costing that to the Federal Government by the lost tax revenue involved.

With regard to the estimation of the economic effects, I think that probably we can make at this point no choice between the two instruments. Many studies have been made but there is a large amount of

disagreement among the experts still as to how fast and how important the effects of either of these two instruments are.

There is, however, one example of a study by Charles Bischoff, reported at Brookings' conference in 1967, which did find that the investment tax credit had important effects whereas accelerated depreciation did not. I don't take that as a definitive result yet but it is a very interesting one and I hope the question will be pursued further.

With regard to side effects, the main one that disturbs me is the side effect of accelerated depreciation, which is its effects on corporate income—the size of corporate profits, which it distorts; and if it gets too much public attention it may mislead investors and others because it does change the amount of reported corporate profits.

The investment tax credit does not do that.

Finally, with regard to the flexibility of the instrument, I think that given the uncertain world in which we are operating, we can expect to want to change the magnitude of the subsidy instrument as a stimulus to economic growth and, it seems to me, that the investment tax credit can be used in that way more readily than can accelerated depreciation, that the companies can comply with changes in the credit more readily than they can with changes in accelerated depreciation.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Thank you, Mr. Break.

Mr. Hendrick Houthakker is an old friend of this committee and really needs no introduction. He testified numerous times when he was a professor both at Stanford and Harvard Universities; and, of course, most recently as a member of the President's Council of Economic Advisers.

At the time you left that, I had occasion to remark about how fine and outstanding a professional job you did. We have had eminent economists serving on the Council over the years and you certainly rank with the very best.

Mr. Houthakker recently returned to Harvard where he is professor of economics.

It is good to see you again, Mr. Houthakker. Go right ahead.

#### STATEMENT OF HENDRIK S. HOUTHAKKER, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. HOUTHAKKER. Thank you very much, Mr. Chairman. I certainly appreciate your very kind remarks. I am sorry I arrived late here, as a result of weather conditions, and missed your opening statement.

The Joint Economic Committee has once more put the country in its debt by tackling one of the most difficult problems in Government. In my statement, which is mostly addressed to what we can do about special benefit programs, I shall have something to say about conceptual questions, too. But no matter how we categorize subsidy or special benefit programs, most of us would agree that they are getting out of hand. In every session of Congress some new programs are enacted, sometimes on the basis of careful and dispassionate analysis and sometimes not.

Usually these programs are small to begin with, or at least the initial estimates are small, but frequently they mushroom after a short time. Amtrak is a clear case in point.

I believe it is fair to say that the need to subsidize long-distance railroad passenger traffic has not been demonstrated, since satisfactory alternatives such as planes and buses are available. Apart from a desire to relieve the railroads of an unnecessary burden, the support for Amtrak appears to have reflected mostly nostalgic and fashionable prejudice against private cars. The prospective cost to taxpayers was understated. Now the chickens have come home to roost and the Federal budget will probably be swollen by another few hundred millions of dollars, only one-tenth of 1 percent, to be sure, but then there are many other programs that, like Amtrak, are more expensive than originally thought and are hard to get rid of. We need better control mechanisms and with your permission I shall now read parts of my statement which is quite short.

Some explanation is needed as to why I have chosen to depart from the general title of this compendium, and to talk about special benefit programs rather than subsidies. The reason is simply that special benefit programs can probably be defined with somewhat greater accuracy than subsidies. In the staff study a very thorough attempt has been made to define subsidies and to list the subsidy programs of the Federal Government; no doubt similar attempts will be made in the other compendium papers.

My own starting point was also an attempt to define subsidies, but in the course of doing so I came to the conclusion that the concept of a subsidy is just too elusive. There is probably general agreement that farm price supports are in the nature of a subsidy program and that the administration of justice is not. Indeed most students of the subject would probably include the majority of the subsidy programs listed in the staff study, though they might be inclined to add a few or delete others.

It is because I shall be mostly concerned with the control of these programs that I have chosen to follow a different, though a largely overlapping, definition. Anyone who goes through the listing of subsidies prepared by the staff will be struck not only by the large number but also by their extreme diversity, both as regards nature and as regards amounts of money involved.

We find a program, the Postal Service, with which we are all familiar and which costs about \$1.5 billion per year, and another one costing only about \$8 million (it is a domestic ship-scraping program), the mere discovery of which is something of an achievement.

It seems clear that we cannot hope to control such different programs by the same mechanism. The problems of the Postal Service have been before Congress many times and undoubtedly could bear further scrutiny, but it is not obvious that treating these problems under the rubric of a subsidy program will lead to much progress.

On the other hand, the very small ship-scraping program unearthed in the staff study will probably not attract much attention except as part of a more comprehensive study. Similarly, it may well be useful to talk about rural electrification in the context of this study, for instance, but I rather doubt that much progress will be made here with the tax treatment of capital gains, whose classification as a subsidy program is in any case open to question.

Without denying that there may be a subsidy element common to a large variety of programs, both large and small, I nevertheless feel

that it is more useful to concentrate for the time being on programs of more restricted scope. The wide dispersion of the effects of the postal subsidy, or of the tax treatment of capital gains and owner-occupied housing, really puts them in quite a different category from the preference to domestic ship scrappers or rural electrification or even a large program such as agricultural price supports.

That is why I am confining my discussion to special benefit programs, by which are meant Government programs that modify the operation of the market mechanism or of the tax laws for limited sectors of the economy or limited groups of the population. To qualify as a special benefit program, a program should have a direct effect on no more than a given percentage of the GNP or of the population, but the indirect effect, including the cost to taxpayers and/or consumers, may be widely dispersed. How high this limiting percentage should be is a question that will be further discussed.

The category of special benefit programs thus defined is narrower in some respects and wider in other respects than the category of subsidy programs. A special benefit program need not involve a subsidy in any of the forms recognized in the staff study, except if the concept of benefits in kind is interpreted very widely.<sup>1</sup>

The Davis-Bacon Act, for instance, can be regarded as a special benefit program for the construction unions since it greatly reinforces their control over wages. It is not listed as a subsidy program in the staff study, though it could have been so listed without doing much violence to the principles applied to other cases.

Similarly, the Jones Act, which reserves coastal shipping to U.S. carriers, does not involve any overt transfer of income, yet its effects are similar in some respects to a subsidy for coastal shipping paid by the shippers and/or receivers of commodities that are or could be transported by this means.

Many other examples could be given. On the other hand, the tax treatment of owner-occupied housing, which constitutes a subsidy according to the staff study, should not be included among the special benefit programs, since about half of the housing is owner-occupied. Here I should perhaps reiterate what you said, Mr. Chairman, about the subsidy study as a whole, namely that to label a program as a subsidy is not to say that it is good or bad; the same applies to special benefit programs.

Other papers in this compendium will no doubt deal at length with the advantages and disadvantages of special benefit programs or of subsidy programs. I shall therefore be brief in stating the reasons why special benefit programs in my opinion should be brought under stricter control than has been the case so far and why the achievement of such control will be difficult.

First of all, to the extent that special benefit programs involve Government expenditures they are merely another instance of the difficulty of evaluating Government expenditure programs generally. All such programs receive a considerable degree of scrutiny by the Congress and by the administration but a certain amount of waste has occurred nevertheless.

<sup>1</sup> At some point the staff study does appear to give this wide interpretation to benefits in kind; thus the subsidy to domestic ship scrappers mentioned earlier is classified as such.

Congress is not always adequately equipped to evaluate expenditure programs; the device of holding hearings is far from being a complete substitute for objective evaluation. All too often hearings are dominated by the special interests who expect to benefit from the programs under scrutiny rather than by those who have to pay for them; thus representatives of nonfarm sectors are rarely heard by the congressional committees on agriculture.

The Joint Economic Committee itself has done yeoman's work in attempting to rectify this defect, primarily through education, but much remains to be done.

Within the administration, the Office of Management and Budget does an outstanding professional job of evaluation of present and proposed expenditure programs, but its recommendations do not always carry the day. A recent case in point is the establishment of the National Railroad Passenger Corporation, Amtrak, where Congress and the administration went ahead with a program that may well cost several hundred million dollars per year without any adequate analysis of its costs and benefits.

Another reason why special benefit programs need particular attention is the inertia in our political system, which tends to preserve such programs long after their initial justification, if indeed there was one, has disappeared. These programs tend to create vested interests, whose anguished cries of ruin at the slightest suggestion of reform are usually loud enough to drown out the voice of reason. Even if a program is widely conceded to be unsatisfactory, Congress is likely to let sleeping dogs lie by extending it unchanged rather than reforming it. The recent extension of the Sugar Act is one example. The laxity of our rules concerning political contributions may well aggravate the problem of inertia.

A third reason why special benefit programs need new forms of control is that they are especially subject to logrolling. It is my impression, not based on careful analysis, that the traditional role of the rivers and harbors bill in this process has increasingly been taken over by special benefit programs. As a result we are gradually moving toward a situation where everybody is subsidizing everybody else.

Most economists will condemn this trend because it is not likely to promote the efficient allocation of scarce resources, but it should be realized that from the political point of view it may have positive aspects.

As we all know from birthdays and Christmas eves, the exchange of gifts, even of rather useless gifts, frequently helps to stimulate good fellowship and a sense of community. One could be more sanguine about this trend, however, if it did not contain an element of self-deception, in the sense that the beneficiaries of any particular program feel they are getting something for nothing.<sup>2</sup>

The three difficulties just mentioned are serious but not insuperable. Within the democratic process they can be overcome primarily by

<sup>2</sup> This same phenomenon appears in the case of another program that should probably not be classified as either a subsidy program or a special benefit program; namely, revenue sharing. It is understandable that State and local officials would like to have their financial worries taken care of by the Federal Government, but it is not equally clear why their constituents, who are also Federal taxpayers, would consent to this shift, which transmits the control over expenditures to more remote decision points. This does not mean, of course, that the division of financial responsibilities between Federal, State, and local governments should necessarily remain the same forever.

better information and analysis. The Joint Economic Committee's subsidy study itself is a useful move in this direction, but it needs to be put on a more formal and permanent basis. I therefore propose the creation of a joint committee on special benefits programs, whose task it would be to report to Congress on the effects of selected special benefit programs according to standards discussed in a moment.

As a joint committee, it would not have legislative responsibility, which would remain with the present committees, thus avoiding jurisdictional disputes. However, its reports would not merely be academic studies but would be required by law in certain cases. The legislation setting up the proposed committee would itself designate certain programs as being within the purview of the committee, and subsequently other programs could be added under the legislation establishing these programs themselves.

Thus if an old program were extended or a new one introduced, the relevant legislation would direct the joint committee on special benefit programs to report to Congress before a certain date. The joint committee's reports, however, would not be binding on Congress and would derive their authority primarily from the quality of the analyses contained in them.

In some respects the joint committee on special benefit programs would be similar to the Joint Committee on Internal Revenue Taxation, which provides the House Ways and Means Committee and the Senate Finance Committee with professional analyses of revenue proposals. The most important difference, apart from the subject matter, would be that the proposed joint committee would not work for any particular House or Senate committee. The membership of the joint committee on special benefit programs would therefore be particularly important; it should include, *ex officio*, the chairman of the respective committees on Appropriations and Government Operations, as well as of the Ways and Means and Finance Committees. The chairman of the proposed joint committee, however, should not be the chairman of any one of the committees mentioned, though he might be chairman of the Joint Economic Committee. In fact, if the establishment of a new joint committee turns out to be too difficult, a start might be made by having a subcommittee of the Joint Economic Committee perform the same functions temporarily.

The reports issued by the joint committee would involve the following:

(1) They would identify the direct beneficiaries of the program in question. In most cases this will be fairly straightforward. Thus, under the oil import program the direct beneficiaries are the refiners who receive tickets to import crude.

Under the agricultural conservation program, the direct beneficiaries are the farmers who receive subsidies for applying lime and other practices.

The reports would classify the direct beneficiaries according to income size, location and other characteristics. In addition, the reports would estimate the benefits obtained by beneficiaries, both gross and net. This distinction, which is also made in the staff study, can be illustrated from the case of a price-supported crop.

The gross benefit to the farmer is the difference between the support price, free market price if there was one multiplied by the size of the crop.

The net benefit would take into account the changes in inputs and in nonsupported outputs that result from price support programs. Thus farmers generally find it profitable to use more fertilizer as the price of a crop goes up and the cost of the fertilizer is one of the items differentiating gross from net benefits.

The reports would also determine whether the net benefits received would be taxable and to what extent they are actually reported on tax returns, so that the direct benefits can be considered both before and after tax.

(2) Even more important, and more difficult, is the identification of indirect beneficiaries. In many programs the direct beneficiaries serve only as a pass-through, and in some cases the direct beneficiaries may not receive anything of value at all.<sup>3</sup>

In many special benefit programs the indirect effects are much larger than the direct effects. The oil import program, for instance, serves not merely as a subsidy program for refiners who may, in fact, pass on some of the benefits to consumers, but in conjunction with market demand prorationing it is also essential in keeping the domestic price of crude oil above the world price.

The interstate highway program, which I would not necessarily include among special benefit programs, is strongly supported by highway builders who have generally been lukewarm at best about toll roads. The calculation of indirect benefits is going to take hard work but it is necessary to understand why special benefit programs enjoy so much support.

(3) The direct costs of a special benefit program are relatively easy to determine if it involves a subsidy but somewhat harder if it raises prices to consumers. As with direct benefits, it would be useful to know not only the total direct cost but also the distribution by income and region—readily available for the personal income tax, the principal source of Federal subsidy funds.

(4) The indirect costs can vary greatly in nature and magnitude, and frequently even a simple listing with only crude orders of magnitude will be revealing.

An evaluation of the total impact of the various agricultural programs, for instance, would involve difficult judgments about labor mobility, patterns of location, imports and exports, and a host of other considerations. For one special benefit program where a fairly full evaluation of direct and indirect costs and benefits has been made—the oil import program, it was necessary to go deeply into the security of our energy supplies, which, in turn, depends on economic, political and geographical factors. What this means is that the joint committee would need a sizable and highly qualified pro-

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<sup>3</sup> Personal experience has provided me with a fragrant case in point. Some years ago I bought a farm in Vermont which had not been in commercial operation for several years prior to my purchase. I became a member of the local soil conservation district, and was told that after a certain lapse of time I would be eligible for a government subsidy of about \$400 on the construction of what is technically known as a "wildlife pond". In view of the recommendation to surround the pond with barbed wire it was apparently meant for the birds, but that is another matter. It turned out, however, that the subsidy would be available only if the pond were dug by an approved contractor, and that (at least at that time) there was only one contractor in that category. The approved contractor wanted about \$2,500 for construction of the pond and related work, although a non-approved contractor from another part of Vermont said he could do it for about \$1,000. The subsidy would, therefore, in effect, have gone to the contractor and the property owner would have no incentive to build the pond.



fessional staff, even though it would no doubt draw on outside help as well.

(5) On the basis of these four factual and analytical studies, the joint committee would make an evaluation of the program under consideration. In particular it would consider:

(a) Whether the program does, in fact, achieve the goals laid down in the original legislation, whether or not these goals are still appropriate.

(b) Whether the direct and indirect costs of the program are commensurate with the direct and indirect benefits; more specifically, how many dollars of cost are required to obtain \$1 of net benefit.

(c) Whether there are better ways of achieving the original goals of the program or of providing the same net benefits at lower costs.

(d) Whether the redistribution of income occasioned by the program is generally from low incomes to high incomes or in the opposite direction.

(e) Whether a particular program is consistent with other programs; for instance, programs to increase agricultural productivity may be inconsistent with programs to curtail output; and, if not, how better consistency can be attained.

(f) Whether the original goals of the program are still appropriate and, if not, how the program could be terminated without unduly disrupting the industries or population groups affected.

A few words should finally be said about the order of priority in which special benefit programs would be evaluated by the proposed joint committee.

In the beginning, it was argued that for a program to be considered a special benefit program it should not have a direct effect on more than a given percentage of the GNP or the population. Obviously, the higher this percentage, the more programs will be included, and the larger the constituency of each additional program will be. One strategy would be to start with a low cutoff percentage, thus keeping down the agenda of the committee and hopefully the opposition to reform.

Another advantage of this approach is that the committee and its staff can gain some useful experience in the evaluation of special benefit programs.

The obvious disadvantage is that evaluation of the programs considered under this cutoff may not make the headlines, and thus deprive the committee of much needed support from the general public.

A compromise solution would be to set a moderate cutoff percentage, say 1 or 2 percent of the GNP or the population, and initially work only on selected programs. Depending on the reaction of Congress as a whole, and since this is primarily an educational effort—the results may be slow in coming—the evaluation procedures can then be modified or extended.

I believe that the creation of a separate body for the control of special benefit programs will soon be recognized as necessary for good Government.

Thank you.

Chairman PROXMIRE. Thank you, Mr. Houthakker.

I want to commend all of you gentlemen on very fine statements.

I appreciated your reference to subsidy programs becoming kind of like Christmas with everybody giving subsidies to everybody else. That is about what it has come to. I think it is a very interesting psychological benefit that we get that I had overlooked and I suppose it is quite important. We love each other because—especially with Congress playing the part of Santa—there is a gift reciprocation at the time the election comes up. Although three of you have taken different approaches to the subject, it seems to me you have made remarkably similar recommendations.

Mr. Shoup, you recommend a subsidy monitoring board, Mr. Houthakker, you suggest a joint committee on special benefit programs. I am inclined to think on the basis of my experience as Chairman of this committee and the fight I have made over the years to try to expand some of the operations of this committee, tried to get more staff in order to do that, it is extraordinarily difficult, very difficult. The Secretary of Defense said we ought to have a staff capability for analyzing our weapons, and he didn't want us to use their capability because that should be in-house and subject to his own discipline and shouldn't be revealed to the public. If so, they would have to modify their own studies. But to try to get our own systems analysis even though it would be inexpensive, and save billions of dollars over the years, and it would be supportive of the administration, it would be very hard to get it through the Congress because they feel the committee is interested in too big a staff and so on.

I wonder how you would feel about this kind of an approach; if we could neutralize the committee bureaucratizing process and tend to disarm some of our critics by having the General Accounting Office, which is now equipped—it has, as you know, literally thousands of capable accountants and auditors and so forth—have them do the staff work, have them then come up and testify before this committee, say annually or even semiannually, on the progress of various subsidy programs—the overall subsidy approach and make separate studies of the big subsidy programs and analyze each of them over a period of time—how would you gentlemen feel about that kind of an alternative? Do you think that would be satisfactory or do you think we would have to establish either a monitoring board, a separate agency, or have a new committee which would be expressly and specifically designed for this purpose?

Mr. HOUTHAKKER. Mr. Chairman, if I may reply to this, it is a possibility. I don't think it is as good as having the Joint Committee because it would not have the same prestige. Also, the General Accounting Office would need some reorientation. The effort there has—

Chairman PROXMIER. Well, you could throw in one other instrument which has been, of course, the reason why this committee has been able to develop some prestige over the years and that is because we have the President making an economic report to this committee. We hold hearings on it.

Maybe instead of having the GAO make the report, the President should make the report.

Mr. HOUTHAKKER. Well, of course, the President is not always in a position to be completely frank on this either.

The Office of Management and Budget certainly does a very good job of evaluating programs, but many of its evaluations certainly do

not become administration positions because they would be too painful for one reason or another. And that is why I think it has to be an independent body. The General Accounting Office, I think, could be used for this purpose if it had strong congressional backing, which would mean that even when it says something unpopular the officials of the General Accounting Office, who after all are career people for the most part, would not feel that they have jeopardized their own future. I think that is the hard part in this.

The advantage of having it run by a congressional body is that there are people, such as yourself, who are willing to tackle unpopular issues, and that is not something that can be left to career civil servants.

**Chairman PROXMIRE.** Mr. Shoup, would you comment?

**Mr. SHOUP.** I think there is a great deal to be said for having the GAO take over this kind of a function provided, however, that the section set up for this is adequately staffed with additional professional talent, including economists, and for that matter sociologists, and other social scientists, since there would have to be some conjecture or estimate as to elasticity of demand and supply and other technical conditions before a judgment could be passed.

I can see the difficulties in the way of expanding any committee's work on this score, especially on a continuing basis.

**Chairman PROXMIRE.** At any rate, is it fair to say you all agree there is a crying need for some kind of annual, in-depth review for Federal subsidies programs? All of you do?

**Mr. HOUTHAKKER.** Yes, indeed.

**Mr. SHOUP.** Yes, indeed.

**Mr. BREAK.** Yes.

**Chairman PROXMIRE.** I think if these hearings can begin that kind of action that will serve a useful purpose. I think perhaps it is the most important development we can look forward to in these hearings.

As you may know, the West German Government publishes a bi-annual subsidy report as a requirement of their Economic Stabilization Act. Do you feel that we should make any U.S. review of such programs a legislative requirement?

**Mr. HOUTHAKKER.** I would certainly think so, yes. I think the force of law has to be behind this at some point.

If the idea which I proposed, which is very similar, of course, to Carl Shoup's proposal, if this were ever to come about, then the Joint Committee would have to be given some initial assignment but, in addition, whenever a new subsidy program were to be enacted it would be part of the legislation that there would be an annual review, or at least a periodic review of this program by whatever body exists for this purpose.

**Chairman PROXMIRE.** So it would have two or three useful purposes: One, would be to give us a better appraisal and understanding of how the subsidy programs established in the past were working; we might be able to change those, reduce their costs, perhaps to make them more efficient and effective. A second is that we might discontinue some if we knew what they did and did not do; and, third, would be the point you make now when new programs are established if you put through this discipline of analysis first so we would have some idea of what to expect, and we might on that basis substantially modify the proposal or might even not proceed with it, something we

don't do now. We don't determine the costs and benefits of most of these programs, do we?

Mr. HOUTHAKKER. I think it might appeal to Members of Congress, too. My impression is, in view of the vast amount of legislation that has to be dealt with all the time, some programs do not get full scrutiny by all Members of Congress. I think some of them might well be happier if they felt that there was some mechanism for catching up on mistakes if they turn out to have been made; and they might then make it a condition of support that there is such a review mechanism.

Chairman PROXMIRE. Mr. Shoup, the first paragraph of your testimony deserves emphasis. You say, and I quote: "Federal subsidies are the great fiscal unknowns. The Federal budget presents no comprehensive summary of subsidies. Most public finance textbooks in the United States either do not even list the word 'subsidy' in their indexes, or give only a page or two of references. There is no monograph on subsidies in the English language—there are several in German."

Yet the staff study shows that Federal subsidies now cost the taxpayer at least \$63 billion per year.

Why are subsidies the great fiscal unknown? Why is this?

Mr. SHOUP. Why has it happened? I have several conjectures on that score. One, I fear that the public finance economists have been too much preoccupied on the expenditure side by such things as used to be identified by battleships and now by military planes and other instruments which serve a general public purpose, presumably, or let us take a less controversial case, public health measures which, if they benefit one person happen to benefit all of us, that is, measures of general benefit.

Indeed, the original premise on which much of Government activity rests is that the Government supplies services that benefit all of us, services that we cannot buy in the private market because if they are supplied to one person they are inevitably made available to everybody; and there is no easy way for the private market to price these things. So we have no price: public health is simply given free of direct charge. Here, I distinguish medical care from public health measures.

This preoccupation on the part of public finance economists with the pure public good has kept them from looking closely at what Government money is really going for, which in large part turns out to be, as this study indicates, to influence the private market in its operations through changing prices.

Also, perhaps there has been too much of a tendency to regard subsidies as something that are disposed of simply by calling them negative taxes; "since we know all about taxes, therefore we know all about subsidies; just ask us a question and we can give you the answer."

Chairman PROXMIRE. On taxes, isn't there a different kind of psychological attitude for which there is some understandable, justifiable support that a tax, so-called tax expenditure subsidy is a little different? After all, a person is making a sacrifice; he is paying some tax. All you are doing is easing that burden a little bit; therefore it is so much different from a cash subsidy where you give a person a subsidy without reducing the amount of tax that he would otherwise pay.

Mr. SHOUP. Yes, they are quite different forms.

Chairman PROXMIRE. But there is a psychological factor behind it. I think there is less resentment somehow; maybe there shouldn't be but there is, on the part of the public and on the part of Members of Congress toward this tax type approach.

Mr. SHOUP. Yes, but really I am at somewhat of a loss to explain why we have this gap.

Chairman PROXMIRE. It is too little economic analysis.

Mr. Break and gentlemen, I would like to ask each of you this question, too: In addition to setting up a special review process, it seems essential to reform existing means for managing these programs. As it now stands, the U.S. budget seems very inadequate in its coverage of the revenue side of Government activity. There is no accounting for tax expenditures on subsidies, for example, and credit subsidies are not measured in any meaningful way.

Couldn't we go a long way in improving the Federal accounting for subsidies by improving the budget?

Mr. BREAK. Indeed, I think we could. With regard to taxes, which is one of my own major interests, I think it would help to have more testimony before the Ways and Means and Senate Finance Committees by people lacking a special interest in the particular provisions being discussed in the tax laws. An organization that I happen to be associated with, is attempting to do something radical in this area. It is Taxation With Representation, which I believe you are familiar with. I hate to suggest this today but it might be desirable to subsidize bodies like Taxation With Representation. It is having great difficulty surviving and getting funds, and I think rational economic behavior would say one shouldn't contribute to that organization because one hopes to get the results that it is providing without having to contribute and it will be an interesting case to see whether it is able to survive on the basis of voluntary private contributions.

Chairman PROXMIRE. I certainly wholeheartedly support that but my question was a little bit different. It is aimed at the kind of information that would be supplied and highlighted in the budget. In other words, a good deal of effort to analyze tax expenditures, a real effort to determine what credit subsidies amount to so there will be an awareness, a basis for focusing on this particular cost.

What I am getting at is, shouldn't we identify both tax and credit subsidies in the budget?

Mr. BREAK. The difficulty I see with the tax expenditures is that most of those items that are listed in the staff study's table and in the Treasury's original study are multipurpose. They are not just subsidy instruments; they are there for various reasons and it is very hard to specify all those purposes and the subsidy elements in some of them may be a lot smaller than it looks at first glance; and it certainly would be helpful to make an indepth analysis of that, but I don't think there is any easy way to get a list of tax subsidies as such.

You can list features of the tax law that for various reasons you think should be changed, but some of those reasons have nothing to do with the subsidy elements in them.

Chairman PROXMIRE. Do you think those problems are so great that it wouldn't serve a purpose to try to identify regularly and clearly what might be construed as tax subsidies?

Mr. BREAK. I think it should be tried.

Chairman PROXMIRE. It should be done but we ought to be aware of the limitations?

Mr. BREAK. But we should look carefully at what should come out. It should be done.

Chairman PROXMIRE. My time is almost up, but I would like to ask one more question, if you will permit. It is a technical question along the same lines.

Shouldn't credit subsidies be measured on a capitalized basis, as was recognized by the President's Commission on Budget Concepts of 1967?

Mr. BREAK. Yes; I think they should be.

Chairman PROXMIRE. Wouldn't that be a help?

Mr. BREAK. I thought that the recommendations of that committee were very good ones and I hope they will be implemented soon. I don't know precisely what has been done in the budget, in response to that committee's work.

Chairman PROXMIRE. If you other gentlemen would like to comment on this general line, I would appreciate it, that is, with respect to tax expenditures and credit subsidies.

Mr. HOUTHAKKER. On the question of tax expenditures, I think Mr. Break has put his finger on one of the main problems. There is a considerable amount of arbitrariness in defining them. When Stanley Surrey was Assistant Secretary of the Treasury—

Chairman PROXMIRE. Incidentally, he is going to testify tomorrow.

Mr. HOUTHAKKER. I am sure he will get back to it—he was responsible for making a special analysis of tax subsidies and this was very revealing.

Nevertheless, almost any particular item in there can be subject to some disagreement.

Now, maybe one should not abstain from doing something because it cannot be done with complete precision; but there is a certain area of fuzziness there and this is why to put it in the budget is something that should certainly be considered. But I am not sure that there will be enough agreement on what should and should not be included. It might be better to do what was done for this particular subsidy study we are discussing now, to give the Treasury a list of programs and ask them to come up with their best estimates of what these programs do.

This approach does not put Treasury under the same obligation of deciding what programs should and should not be included.

Chairman PROXMIRE. Mr. Shoup.

Mr. SHOUP. I am inclined to take a rather more positive view, perhaps, than Mr. Houthakker on this point.

It seems to me it is not too difficult to isolate major parts of the tax system that are truly subsidies. Even though the boundary line is difficult to draw and although I would hesitate indeed to put these right into the budget next year, nevertheless, I think further investigation can reveal ways of computing the subsidy elements fairly closely. Compared with other types of subsidies, we find that the difficulties are not unique in the tax subsidy field.

Chairman PROXMIRE. My time is up, Mr. Blackburn. I will be right back.

Representative BLACKBURN. Thank you, Mr. Chairman.

I want to congratulate each of you on a very outstanding piece of work. I agree with the chairman, you may all have taken a little different approach in the beginning, but I think you all have come pretty much to the same conclusion; that is, Congress has to exercise a better oversight function over subsidy programs and the effectiveness of subsidy programs.

Of course, it is the responsibility of the respective authorizing committees to exercise that oversight. As a matter of practical politics, the vested interests that look forward to receiving these subsidies seem to have an ability to get proponents of their views on the committee, so the result is that the authorizing committees are sometimes not as dispassionate in evaluating the performance of their programs as they could be; and whether it should be the duty of this committee or a similar joint committee is, I think, a rather interesting suggestion, because it would separate the overview function from the authorizing function, and perhaps we could get more, as I say, dispassionate view of some of our approaches.

I don't want to really get into specific programs at this point because I think it would be too early. In Mr. Shoup's statement, I heard an interesting observation. It says:

Suppose, to vary the case a bit, that the subsidy does not even lower the price to consumers. This could occur if it turns out that expansion of production of this particular good is very costly or almost impossible at any price. Then all that happens is that the producers of this good get a much higher price, including the subsidy, and consumption is not appreciably increased.

The thought that occurred to me is, it is possible that this is what is happening in the case of medicare. We just have so much of a medical machine, so much in the way of doctors and hospitals and technicians, et cetera; and through Government subsidy programs, we have suddenly made more demands on the same machine.

I would like your reaction to that thought, Mr. Shoup.

Mr. SHOUP. Without having myself studied this field intensively, I may say that I get the impression from what I have heard in your statement and elsewhere that your suggestion is correct and that because of the difficulty of increasing rapidly the supply of medical care, we have at least transitionally the fact of the pressure of greatly increased demand, fortified by the subsidy money, a program, by the way, which I support wholeheartedly over the long run, but a program which, in the beginning at least, has indeed run up against a necessarily somewhat unresponsive supply. It takes time to train doctors; it takes time to develop and to build hospitals. So it is no wonder that the increased demand financed by the subsidy has pushed prices up. One can't blame the doctors and the hospitals or anyone else for accepting higher pay. It is simply a natural reaction of the private market.

Representative BLACKBURN. So what we are counting on is that the lucrative incomes that are being received will attract additional people into the medical field; however, they will be competing with each other somewhere down the pike, and the cost per individual for service will be reduced. At least in theory, is that what we hope happens?

Mr. SHOUP. Yes.

Representative BLACKBURN. Perhaps some Government program to encourage more people to go into medicine will be a more effective subsidy.

Mr. SHOUR. We might even have a producer's subsidy to stimulate producers of these goods.

Representative BLACKBURN. In your statement, Mr. Houthakker, you observed that the classification of the tax treatment of capital gains as a subsidy is in any case open to question. I agree with your observation. I would like first to ask Mr. Break if he agrees with this observation, and then I would like Mr. Houthakker to explain it further.

Mr. BREAK. Yes, I do agree with that observation. I would support full taxation of capital gains at the individual level, but I think you have to also think about what you are going to do with the corporate income tax once you move in that direction; and my own solution would be to remove the corporate income tax entirely if you were going to tax capital gains fully at the personal level. So I think that whereas there is a subsidy at the individual level because capital gains are taxed more lightly, at the corporate level there is the opposite, which is a separate and additional tax that I think corporate stockholders bear in part, and I think you have to treat both together; and that is one of the reasons why I am skeptical about listing capital gains subsidies of about \$7 billion, or whatever it is, as tax expenditure because it overlooks this complex corporate tax relationship with capital gains on shares.

Mr. HOUTHAKKER. Congressman, my view on this is there is a case for taxing capital gains. I am not arguing for a moment they should escape taxation altogether.

On the other hand, I have heard eminent specialists in public finance say flatly that capital gains are income which implies they should be taxed at the full rate. I can't go along with that either. Capital gains are to a large extent the result of changes in the general price level through inflation. It does not make much sense for the individual to be taxed, say, the increase in value of his home if this is judged on any basis by which taxation is usually justified, ability to pay, benefits received, or whatever it is. I think therefore, that the present treatment of capital gains at a reduced rate does make some rough degree of sense, even though the actual rate used may not be the right one; and that is why I have some doubt about the justification for including it here. But I recognize that people who know more about the subject than I do have different views.

Representative BLACKBURN. I would like to explore further with Mr. Houthakker his observation regarding the proposed revenue-sharing programs.

I personally do not support revenue sharing because I feel that a philosophical question arises in that if the local citizens are not willing to undergo the tax burden to pay for local improvements or local services, then what right do I have at the Federal level to impose the Federal income tax on the same citizen and then send it back to the local governing authorities to use for local purposes that perhaps the local citizens don't want or would not support with their taxes.

Do you have any suggestions? I would like to ask Mr. Break the same question, too, because he, I understand, specializes in taxes. Any



suggestions as to methods whereby we could open avenues for taxation to local governments that do not now exist, and keep the taxing responsibility connected with the spending responsibility would be appreciated.

I know Secretary Romney was telling me the other day that one of the big problems in our public housing programs is in the fact that the Federal Government agrees to pay any operating deficiencies and yet the local authorities manage the properties. So it is a very happy relationship. It would be as if I were in business with somebody and I had the power to spend the money and he agreed to make up any deficiencies we had.

So I agree we have to have this corresponding relationship between the taxing power and the spending power.

Do you have any suggestions as to alternative approaches other than revenue sharing?

Mr. HOUTHAKKER. Well, let me first say that what bothers me about revenue sharing in particular is that it undermines our State and local governments by taking away responsibility; and I fully agree with what you said that people at the local level should decide for themselves whether their expenditures are worth it to them.

The control is removed when all of this comes out of the same pot.

Now, it is true that the tax structure at the State and local level does have limitations, so that State and local governments cannot go as far as they should at the moment in obtaining necessary revenues.

One proposal which I have always liked—I don't claim to be a specialist in this at all, but it has always made a lot of sense to me is the tax credit approach in which taxes paid to State and local governments are a direct offset to taxes paid at the Federal level. This does leave the initiative and the responsibility at the local level and nevertheless does something for the States and local governments in view of the lack of elasticity in their revenue base.

Representative BLACKBURN. Mr. Break.

Mr. BREAK. Yes; I think that one of the big problems is that State and local governments are reluctant to raise their tax rates very far above those of their neighbors and I take that to be the case because they feel that some of the benefits of the expenditure of that money are not going to be confined to those areas or else raising the tax rate wouldn't be so unattractive; and that suggests to me that we should try to do more than we have so far done to finance those benefits that go outside the jurisdictions of the State and local governments at a higher level of government.

I would like to see the Federal Government for example, take a larger share of welfare costs which I think is a national benefit program, and similarly a higher share of education costs; and it seems to me if that were done the need for revenue sharing might not materialize.

Representative BLACKBURN. My time has expired. I want to make this observation, however.

I appreciate your suggestions as to alternatives. What you are saying in effect is that we should recognize that some programs that are being administered at the local level are really national programs in effect and in operation, and we should relieve the local government of

these burdens. This would indirectly increase their revenues for other things.

Mr. BREAK. Right.

Representative BLACKBURN. Well, thank you, gentlemen. I have other matters to attend to, but, again I want to thank you for your very fine appearance here this morning.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Mr. Houthakker, in June of 1970; that is, about a year and a half ago, at the same time he created the Productivity Commission, President Nixon also established the Regulations and Purchasing Review Board. In his words, the Board's objective was that "all Government actions will be reviewed to determine where Federal purchasing and regulations drive up costs and prices."

Since the Federal Government is the largest purchaser of goods and services in the world, an essential part of any price stabilization program would include scrutiny of Government spending practices.

The Board, however, has not even remotely exercised the authority granted by the President. As far as my staff can determine, it has issued only one progress report, more than a year ago, and it has not even met since August 1971.

Mr. Houthakker, you were a member of the Board's working committee during your tenure at the Council of Economic Advisers. Would you please comment on, No. 1, how effective has the Board been in reviewing and revising Government spending practices to reduce inflationary pressures?

Mr. HOUTHAKKER. Well, I have to concede that the Board has not lived up to its promise at all.

When the President made his speech in June 1970, it was thought this Board would be a very important vehicle in identifying programs that cause inflation, not only those connected with Government purchasing but also in a large variety of other methods such as import controls, the Jones Act, Davis-Bacon Act, a number of items like that.

Now, the Board has never met very frequently for reasons which I don't pretend to understand. It was very late getting started.

It did some work subsequently on particular areas. For instance, in the area of public buildings I remember some study which I thought was useful on changing the methods by which the Federal Government acquires new buildings.

There have also been studies of other subjects. For instance, the Jones Act was studied at considerable length. The Jones Act has become especially important as a result of the oil discoveries in Alaska. If we ever manage to bring this oil down to the Gulf of Alaska, then, of course, it will be a problem of how to get it to the mainland unless it goes through Canada.

Now, the work done by the Board on the Jones Act, as far as I know has not led to any great result so far.

I think the problem is simply that the items which the Purchasing and Regulations Review Board was trying to deal with are all extremely sensitive ones except maybe things like Government buildings.

Chairman PROXMIRE. What were the findings on the Jones Act?

Mr. HOUTHAKKER. On the Jones Act the findings were made that the cost was quite large. I don't remember the exact figure now—and

that an attempt should be made to remove it. But the Jones Act, although—

Chairman PROXMIRE. To repeal the act?

Mr. HOUTHAKKER. To repeal it or modify it. I think that outright repeal would create serious transitional problems but at least there are ways of modifying it.

For example, exemptions would be given for certain kinds of traffic. There are already exemptions under the Jones Act; I believe that it is lumber from Alaska or some product like that which is already exempt from the Jones Act, so that exemptions are not unknown and that was one avenue explored by the board.

But I have not heard much about it since I left the Government myself.

Chairman PROXMIRE. You know, Mr. Houthakker, it is really appalling when you think of it. This administration, it seems to me, has concentrated more energy, more effort and intensity of effort on inflation than anything else and, as I say, the Federal Government is the biggest purchaser in the world and it can have in several areas serious impact on inflation. It was a board created by the President in that speech for that purpose and it does nothing. It is appalling.

In this particular area, it would be one thing if it were a board designed to deal with something else in which the administration has been less interested or less alert, but they have been very concerned about inflation.

Mr. HOUTHAKKER. It is fair to say that the failure of this board was one of the many reasons why the administration was finally forced into the August 15 program. I think the speech which the President made in June, 1970, was recognition of the adverse impact of various limitations of competition had on our free enterprise system. But when it comes to the point of reform, most of the programs investigated turned out to be so strongly entrenched there wasn't much that you can do about them.

Chairman PROXMIRE. That is an interesting conclusion because I think we may run into the same problem with respect to what we are trying to work on now. We ought to be prepared for it.

Do you think the possible inflationary impact of Federal subsidy programs is a legitimate concern of the Regulations and Purchasing Review Board?

Mr. HOUTHAKKER. I am sure it is part of the charter, yes; and there are people who would like to use it in this way, but even within the administration this has turned out to be extremely difficult.

Chairman PROXMIRE. Can you cite any examples from your substantial experience of subsidies and other special benefit programs contributing to the wage-price spiral?

Mr. HOUTHAKKER. Well, I think that the whole area of the Davis-Bacon Act has had all of the potential—

Chairman PROXMIRE. Right.

Mr. HOUTHAKKER (continuing). And I think the suspension of the Davis-Bacon Act in January or February of 1971 can to some extent be credited to the activities of the Purchasing and Regulations Review Board. Now, this suspension was not maintained. After a month or so the suspension was revoked and another mechanism was erected. But this, I think, is one of the most critical areas.

In the case of the construction labor force, we have supply limitations that really are medieval. It is very hard to enter the construction unions even though there are lots of employment opportunities there and, as a result, the wage increases, as we all know, have been quite staggering. This is one area where something could be done, and something was done in the way of suspension of the Davis-Bacon Act, but there again the counterforces were so powerful that after a while something else needed to be done.

I think it illustrates a very general problem that our economy appears to have become extremely rigid in certain areas.

We have set up mechanisms to protect various vested interests and we cannot find the public support for doing away with them.

Chairman PROXMIRE. Of course, I think that there would be more public support if there would be more effort, and I am not just criticizing this administration, or any administration, but if the Members of Congress and the President of the United States would really hammer away at this hard, I think we would develop a whale of a lot of public support because I have found in my State there is great, deep, broad support for holding down unnecessary wasteful spending. I think that it is the most popular—people talk about it being unpopular—issue there is.

Mr. HOUTHAKKER. I wish there were more States where this issue was brought home to the public. In most of my work, and much of my work on the council concerned problems like this, I have generally not found it easy to show any public support for dealing with particular restrictions whether it was steel or milk or what have you. It always comes to the same thing, that the special interests have the inside track.

Chairman PROXMIRE. Well, it has to be done; I think it has to be done, in a broad way and it could be done preferably, of course, by the President of the United States because of the great prestige and attention he has; he can win and organize public support.

You raised the very serious problem about what the Congress ought to do about Amtrak. It was originally funded as a \$40 million subsidy and a request of \$170 million is now before us. You say that the cost of this subsidy was understated to begin with and I think you are right. The question is what to do about it now.

You are right, there is presently not enough private demand for long-haul passenger service and all these routes are losing money.

But what about passenger trains for the high density corridors, such as Boston to Washington, where the routes are making money and the train service meets some of our mass transit needs? Would you give us your detailed recommendation on what Congress should now do about Amtrak?

Mr. HOUTHAKKER. Well, the northeast corridor has been a separate project, I think, from a legislative point of view and in the northeast corridor a case can be made that the traffic is so large and the cost of constructing additional highways is so enormous that passenger train service can really make a contribution there. If you made a cost-benefit analysis then you may well find that it is worthwhile improving the track, et cetera, so as to make the passenger service sufficiently attractive. In this respect, I should perhaps explain that to get high-speed passenger service, which is necessary to compete with

the airlines, you have to make enormous expenditures on track, rolling stock, and signaling equipment. Without that you cannot have trains that run more than 60 or 70 miles an hour and they do not compete even with private cars very effectively, let alone with planes.

Now, when you go outside the northeast corridor then you do not find many routes with anything like the same characteristics.

When Amtrak was first proposed about 2 years ago, I was one of the people looking at this in some detail, and we looked at the traffic volumes on various routes, and we found that even, say from Chicago to Detroit, two large cities with quite a lot of population in between, there just is not a great deal of traffic that would come to the railroad except if the speed were very considerably increased, and that would run again into the hundreds of millions, or even billions of dollars. So that outside of the northeast corridor I just cannot see much of a case for subsidizing railroad passenger service.

Chairman PROXMIRE. But you would agree we should take another look at the possibility of providing support for the northeast corridor where you think there is a case, and that might tie in with our mass transit programs anyway; is that right?

Mr. HOUTHAKKER. I think that is right. I don't want to make any definite statements on the northeast corridor but my impression is that a much better case can be made there than anywhere else in the country.

But the difficulty with Amtrak was in part that originally the bill provided for a very limited network; then it turned out that various Members of Congress, quite naturally were not going to vote for it unless their part of the country also got passenger service, say the route on the west coast which just could not be justified.

Chairman PROXMIRE. You put your finger on it right there. My good friend, the very fine and able Senator from Montana, for example, only five stops in Montana, of course, he raised the dickens about that. If I were the Senator from Montana I would have done the same thing. They depend very heavily on it. And I recall the wounded cries of other Senators from the Western States.

Mr. HOUTHAKKER. Senator, perhaps I may tell one little anecdote. When Amtrak was first discussed, some of the political people maintained that most railroad passengers are Republicans. But the only railroad passengers—

Chairman PROXMIRE. Where do the Democrats travel? On the bus? I know we don't travel on the planes; we can't afford that.

Mr. HOUTHAKKER (continuing). But the only railroad passenger that anybody could mention was Senator Mansfield.

Chairman PROXMIRE. Mr. Shoup, you criticized farm subsidies because you say they are locked into the values of farmland. Could you elaborate on what that means?

Mr. SHOUP. As I understand it, certain parts of the farmland are eligible for a farm subsidy and have been since the beginning of the farm program, and these particular parcels of land therefore are more valuable than other plots of land that have not been made eligible for farm program payments.

Accordingly, over the years, these parcels of land have been sold and resold at prices that assume that Congress would continue the subsidy programs.

The buyers have, if you would like, bought in good faith. Whether they were completely justified in assuming perpetual continuation of the program is a question that is difficult to answer. But they are, in a sense, owners of innocent vested interests and, moreover, these favored parcels of land have served as the basis for mortgages, for loans made on the assumption that the subsidy program would be continued.

Chairman PROXMIRE. What do you think Congress can do about this? How do you think we can change it to improve it?

Mr. SHOUP. I would myself suggest a gradual phasing out of some parts of this program over a period of 10 or 20 years, which would indeed, I am afraid, harm some innocent purchasers and possibly some lenders; but a gradual phasing out, at least, puts future buyers on notice, and allows for elimination of parts of the program without too much hardship.

Chairman PROXMIRE. Mr. Break, would you comment?

Mr. SHOUP. A completely abrupt change, on the other hand, I think, would be completely unjustified.

Chairman PROXMIRE. Mr. Break, would you care to comment on that?

Mr. BREAK. Yes. I think we have the same kinds of problem with the property tax. There is a lot of talk about—

Chairman PROXMIRE. Especially out in your State.

Mr. BREAK (continuing). Reducing the role of the property tax and lots of property values reflect the presence of that tax.

I am probably not quite so tender with these investors as Carl is. I tend to feel they made that investment and investments can go wrong and they can go right and this should not be an insuperable barrier to the Government's doing something that it believes is desirable on its merits. Not doing it abruptly, quickly, is certainly desirable but I think we ought to move ahead and recognize that these risks are taken by everybody when they make investments.

Chairman PROXMIRE. How about—all of you gentleman have an interest in this; I know Mr. Houthakker has been an outstanding expert in the farm area although I have disagreed with some of his conclusions—how about—recognizing the fact that farm income is low, low on any basis, low on the basis of comparing farm income and other income, low on the basis of the hours of work the farmer does, low on the basis of fantastic increase in efficiency, you know the real difference between the efficiency of this country and the efficiency of the Soviet Union isn't in industrial production; it is in farm production. They have seven times as many people producing food as we do and they are producing 20 percent less food.

In the last several years we have had almost three times as great an increase in the efficiency on the farm as we have had in the rest of the economy and with the hard work the farmer does, the long hours of work he does, many farmers are not making \$1 an hour, at least if you consider the work he does and his wife and children.

Under these circumstances it is not only inequitable but perhaps it is unwise economically not to recognize the enormous advantage to our economy of having an efficient farm system. I have had a lot of sympathy for the NFO, the National Farmers Organization; their feeling that labor is organized, business is organized to a considerable extent, but farmers are not—do you think this would be a better ap-

proach to encouraging that kind of organization so that the farmer is in a position to—better position to negotiate for a higher price in the marketplace, taking Government out of the act? Farmers recognize they have a diminishing political clout; there are not as many as there were; they are only about 5 or 6 percent of the population. It used to be 25 percent a few years ago.

Would you think that is the best approach, or do you just think to let it, let nature take its course and let the cruel laws of economics do their worst, but that maybe a slow death, not the electric chair but drop-by-drop Chinese water torture chamber?

Mr. SHOUP. I don't think we can let the so-called laws of economics operate without any control. Certainly I would not think about weakening some groups or blocks while strengthening others.

Chairman PROXMIRE. That is pretty unrealistic, isn't it—break up General Motors, break up the AFL-CIO? Do you think we have to do that?

Mr. SHOUP. Again—

Chairman PROXMIRE. Incidentally, I am not advocating either one of those steps.

Mr. SHOUP (continuing). I am not taking an all or nothing position on any of these things. It is a matter of what direction, what trend, we want to encourage. I would like to see the farm subsidy given for assisting the transition from the farm to the private sector. I think the agricultural subsidies have in fact done this and they should be continued for that reason. I would like to see the farm community helped to adjust to new economic conditions, including still more out-migration, rather than to attempt to allot farming to some given number of farmers or to determine a given amount of farming.

Chairman PROXMIRE. The staff study estimated international trade subsidies of approximately \$1 billion for fiscal 1970. The staff study also says that fundamentally we should not rely on export subsidies as a means for coping with international trade and payment disequilibrium, that it is only a stopgap method.

Would you agree with that? Mr. Shoup first.

Mr. SHOUP. Yes; I agree.

Chairman PROXMIRE. Do you agree, Mr. Break?

Mr. BREAK. Yes; I do.

Chairman PROXMIRE. Mr. Houthakker.

Mr. HOUTHAKKER. I agree. If I may come back to your previous question on farming as to the NFO proposal, that proposal is to control output through voluntary associations; the NFO would like to produce less, so I think NFO turns its back on increased productivity. There has been a great deal of difficulty in farming during the present years but we have to recognize that if the farmers were allowed to organize the way the NFO would like them, they would produce less because that is the essence, I think, of the NFO proposal to control output through voluntary associations, essentially cartels. This has been tried in some areas of farming, not in the basic crops but in some of the California fruits and vegetables where there are marketing orders doing essentially the same thing.

My impression is it also raises great difficulties. My impression is, if you are going to cut production through some cartel device, then some people will be told they can't produce as much as they want to

and this will reduce their income, too. It is by no means clear that income can be helped a great deal by restricting output, quite apart from the undesirable effect this has had on other parts of the economy.

In this respect, I would add that although we certainly have very serious concentrations of powers in the economy, and I am personally all in favor of reducing that power, it is also true to say that many parts of our economy are still very competitive; our economy is still basically quite strong because there are large competitive sectors, and one of those is agriculture, by and large.

So I would hate to see this.

Chairman PROXMIRE. With the NFO approach you would still have the fundamental, basic competition. I recall studying Chamberlain's great work on the theory of monopolistic competition in which he found that only farmers virtually, although there are others, I suppose, but farmers were the best example of pure and perfect competition.

We have in my State still tens of thousands of dairy farmers. No matter what you do in terms of NFO organization or anything else, you still have an immense incentive for efficient operation, for holding costs down and for each farmer producing somewhat more, being able to produce more one way or another. So I think we may be exaggerating the discouraging effect this would have on incentive. It would give the farmer what he seems to need in many cases, that is, a capacity to invest more capital in more efficient equipment and be able to increase his efficiency in that way.

Mr. HOUTHAKKER. But as soon as he increases his efficiency, since demand is not very elastic, the same problem will return again so even if the NFO proposal were adopted it would have to amount to reducing efficiency.

I mentioned earlier the building trades; what has happened there is a very small increase in productivity, from what one could tell from the data, whereas the demand has increased. As a result building wages have gone up tremendously because supply has been controlled.

If this had happened in farming then we wouldn't have a farm problem now but as soon as we do something to increase efficiency in face of a slow rising demand we will have the same problem all over again.

Chairman PROXMIRE. At any rate, you gentlemen feel we should not expand subsidies in the international trade area, to get back to the question asked here?

Mr. HOUTHAKKER. I think export subsidies are generally a mistake and also are very undesirable as an example to other countries.

Chairman PROXMIRE. Are you gentlemen, any of you, aware of the recent study that has been made that indicated that the Export-Import Bank, with all the tremendous amount that they lend, and the highly favorable attitude toward them everywhere, this study indicated they had not increased exports a bit, had no effect on increase in exports? Are any of you aware of that? Would you say that that would not surprise you?

Mr. HOUTHAKKER. I was not aware of this particular study but it does not surprise me very much. I think the Export-Import Bank has done good work in some areas.

Chairman PROXMIRE. It is an unpublished study.



Mr. HOUTHAKKER. But the Export-Import Bank has traditionally concentrated on commodities such as aircraft in which we have practically a monopoly and we could sell our planes without much support. What we have now is a situation, which I argued against very often when I was in the administration, that foreign airlines come to us and say, "We want credit at 6 percent because in our home market we have to pay 8 percent or 9 percent and we won't buy your planes."

Well, this is just bluff. They have nowhere else to go. American made aircraft are generally the most efficient for commercial operations and no airline is going to abstain from buying American planes just to save one or two percent on the interest.

But traditionally the Export-Import Bank has been involved in aircraft financing and they keep on doing it so that is one important area where probably their activity has not helped our exports at all. But there are other areas such as, say, contracting by American firms, where they have had a more positive effect and I would like to have them concentrate more in those areas where there is an additional effect on exports.

Chairman PROXMIRE. You know they have recently been exempted from the budget, which I protested very vigorously but without effect, because I think it was a mistake.

Several years ago, Mr. Houthakker, you wrote an article called "The Great Farm Tax Mystery" in which you said that little farm income is ever paid in taxes. You estimated in the mid-1960's that while farm income was \$13 billion, only about \$3 billion was declared. A recent study done for the committee shows only 43 percent of expected farm income is being reported for fiscal year 1972.

Would you explain to the committee "The Great Farm Tax Mystery"?

Is there a need for further tax reform in this area?

Mr. HOUTHAKKER. Well, the mystery, I think, is still largely there. I should say I have not looked into this for the last 5 or 6 years now. I did this study about 6 years ago, I think, and at that time I identified one particular area, namely, the use of farm losses by wealthy individuals to get in many cases zero taxes. The Tax Reform Act of 1969 did introduce some new mechanism for taking care of this. I think it is too early to say whether this mechanism is adequate or not.

Chairman PROXMIRE. Does that farm income figure include imputed rent and imputed value of food, and so forth, grown and consumed on the farm?

Mr. HOUTHAKKER. Yes, it does, but that is a very small part of it, though. Various attempts have been made to find out what actually happened there. It turned out that farmers do report their gross revenues fairly accurately. The gross revenues reported on farm tax returns is very much the same as those obtained by the U.S. Department of Agriculture by entirely different means so that seems to be all right.

The big difference is in the expenses reported by farmers, and to what extent it is legitimate, to what extent it reflects inadequate reporting, I just can't say. One remarkable thing is that it varies a great deal by region. In the Midwest, by and large, farmers' tax re-

ports do agree moderately well with the USDA estimates of farm income but when you get to areas like California—

Chairman PROXMIRE. That is good to hear.

Mr. HOUTHAKKER (continuing). Or southeast, there is no relation at all.

I remember in one year in the middle 1960's when California, which is the largest agricultural State—not always but usually—had a net farm income according to the USDA of over \$1 billion and I think all that appears on the tax returns was a small net loss.

Chairman PROXMIRE. So it sounds like my Wisconsin farmers are paying their taxes but Congressman Blackburn's farmers we are not sure about.

Mr. HOUTHAKKER. I don't remember Georgia now but the farm income reported is almost entirely from the Midwest.

Mr. SHOUP. If I may add a note, I think part of the trouble comes from the ability of the farmers to use cash accounting instead of inventory accounting which enables them to get a much more rapid writeoff on many things, and to defer income. This stems from the old days when it was alleged very few farmers knew anything about inventory accounting anyway and if they were big enough to hire an accountant the accountant was too far away. Those days, I take it, have more or less passed.

Chairman PROXMIRE. It sounds like the Alexander Pope couplet, "If ignorance is bliss, 'tis folly to be wise." The less you know the less you pay.

Mr. SHOUP. Yes. Accounting is very important in this area.

Chairman PROXMIRE. Mr. Houthakker, you deal with largely overlapping but somewhat different problems of special benefits. You have a different approach from the other two witnesses and the staff study. Now, to the extent that the committee is concerned with pursuing subsidies in the sense of an instrument for deliberately altering particular private market prices and incentives, and we want to evaluate the objectives and effects of subsidies, I take it you pretty much agree with the testimony of the other two witnesses and the staff study: is that correct?

Mr. HOUTHAKKER. Yes; I certainly do.

Chairman PROXMIRE. When it comes to controlling programs that would provide benefits to a small percentage of the society, you distinguish between subsidies and special benefits. A subsidy is not a special benefit if its effects are dispersed throughout the economy, as you say is the case with the postal subsidy.

On the other hand, you would consider as a special benefit some programs that are not subsidies, such as many public works or free use of the inland canal system: is that correct?

Mr. HOUTHAKKER. Yes, sir.

Chairman PROXMIRE. Could you identify for the committee the major special benefits that were not covered by the staff study?

Mr. HOUTHAKKER. I have listed a few here such as the Davis-Bacon Act and the Jones Act. There are quite a number of programs like that. I would say that the marketing order program of the Agricultural Department comes under this heading, too, because its effect largely is to raise prices but it does not involve any direct subsidy to speak of.

There are a number of other areas where competition is restricted. For instance, the import quota schemes we have are of this nature.

Chairman PROXMIRE. I am just about through. I do have a couple of more questions that I think I certainly want to get a reaction on from all of you gentlemen.

All three of you lay down principles for evaluating subsidies that are quite similar. I want to ask you whether this list I am going to read to you now pretty well represents the fundamentals that Congress should have in mind in evaluating particular subsidy programs:

One, to identify the original objective or intent of the subsidy and ask if that objective is still accepted and valid.

Two, to determine if the market conditions are such that the aim of the subsidy is achieved.

Three, to determine how many dollars of subsidy cost are required to obtain each dollar of subsidy benefit.

Four, to determine if there are better ways of achieving the original goals of the program, either by using a different form of the subsidy, or adjusting the subsidy rate.

Five, to determine if the distribution of benefits are to low-income or to the high-income individuals.

Six, to determine if a particular subsidy is consistent with other programs and, if not, how better consistency can be achieved.

We would then phase out subsidy or special benefit programs that did not meet the above tests.

Is that a fair conclusion of what you gentlemen have given us this morning?

Mr. HOUTHAKKER. Yes, sir; I think it is.

Mr. BREAK. Yes, sir; I think it is.

Mr. SHOUP. Yes, sir; I think it is.

Chairman PROXMIRE. Finally, I am concerned about the talk about adding a value-added tax to our revenue system, very concerned about it. I think it is a regressive tax; it is a hidden tax, perhaps an inflationary tax. We intend to have hearings before this committee on it to go into not just the revenue implications which, I presume, the tax writing committees are going to do, but the broader social and economic implications; and, frankly, I am anxious to see it is not enacted; I will do all I can to prevent it from being enacted. But all of you gentlemen have had wide experience in revenue matters, greater than mine certainly, and I would like to ask you for your comments.

Do you support a value-added tax, Mr. Break?

Mr. BREAK. I put it No. 3 in my list of priorities, I guess. My first one would be to make another attempt to close some of the loopholes in the existing Federal income tax. I recognize that our experience with the 1969 Reform Act is not very encouraging, but I would like to see that tried again and I hope that your committee study of subsidies may stimulate some action along those lines.

My second choice would be to enact a direct expenditures act with exceptions and progressive rates.

Chairman PROXMIRE. Direct expenditures tax?

Mr. BREAK. A tax on consumer spending made by families and individuals. There is a tax that—

Chairman PROXMIRE. You say that would be at a progressive rate?

Mr. BREAK (continuing). You could enact it with exemptions and at progressive rates and it gets at, I think, a base that it may be desirable to get at.

Chairman PROXMIRE. It is a very interesting and novel conception to me. Has there been any experience with that kind of a tax?

Mr. SHOUP. India and Ceylon.

Mr. BREAK. Not very much. There has been a good deal of discussion of it. There was a recent article in the *National Tax Journal* arguing that it could be administered reasonably efficiently in a developed country but not in others.

Chairman PROXMIRE. Any European experience?

Mr. BREAK. I don't know of any, not really any experience that would be helpful.

My third, the third priority would be to enact the value-added tax but to combine it with a credit for every person based on the presumed value-added tax on a minimum poverty—level family budget, the same arrangement that Indiana and various other States now have with their retail sales tax. It would be a credit against a person's Federal income tax liability and then if he had an insufficient amount of tax liability he would get a cash rebate and that, I think, could be used to convert the regressive rate structure of the value-added tax or any sales tax into a mildly progressive one. It would change my views toward the value-added tax quite significantly if it were combined and I think it could be done.

Chairman PROXMIRE. Without that, would you oppose the value-added tax, without the third priority?

Mr. BREAK. Without what? Well, I do feel that we need to spend more money on high priority programs, and so I am, if I felt I couldn't get the other three things.

Chairman PROXMIRE. How about increasing the income tax, the surtax like we had before?

Mr. BREAK. Well, what worries me about that is that tax has so many inequities and loopholes now that I am reluctant to push the rates up very much more.

Chairman PROXMIRE. So you would prefer a value-added tax to an increase in the income tax?

Mr. BREAK. With a credit. I don't know what I would do if my only choice were a value-added tax without a credit.

Chairman PROXMIRE. Many of us feel that Congress ought to plug the loopholes. I certainly agree wholeheartedly. We have been trying to do this for years with no success. In fact, every time we pass a bill the loopholes seem to widen, with a few exceptions; depreciation has gone down a slight amount, but the alternative would seem to me there could be more efficiency in Government if we closed the loopholes.

Mr. Shoup.

Mr. SHOUP. I see no need for a value-added tax at the present time or in the foreseeable future. It seems to me that the income tax should be and can be strengthened if we need more revenue. Despite its apparent inefficiencies and areas of unfairness, it still remains our best hope, I think, for obtaining more revenue in an equitable way without harming the economy.

I might add a footnote which may be of use in some later year but not now. A value-added tax or other form of general consumer's tax might be useful if the rate of the tax were varied very considerably between depression and prosperity to act as a countercycle inducement to consumers to stimulate their purchases during periods of depression and to dampen down their consumption spending during periods of boom. I have to say it is a footnote because we are not quite ready for that yet.

Chairman PROXMIRE. Kind of an inflationary method of stopping inflation?

Mr. SHOUP. If you like, an inflationary method of stopping inflation, to put prices up only once. They wouldn't keep going up, as people would reduce their buying. More importantly I think that consumers could be induced to buy during a depression on the realization that if they did not buy then while the tax rate was low—or even negative, that is, a general consumers' subsidy in a depression—they would have to pay higher prices later. But that is a plan for future study.

Chairman PROXMIRE. Mr. Houthakker.

Mr. HOUTHAKKER. Well, I don't particularly like the value-added tax, but I don't quite agree with Mr. Shoup either on the fact that there is no need for it. I think it would be much better if expenditures were reduced, and I certainly support your efforts in this direction, including this study here. I am not too sanguine about how successful we are going to be. I believe we have achieved some slowdown in expenditures but not as much as it could be and the prospects are expenditures will continue to increase.

Now, the income tax, I think, has probably reached a level where it cannot be increased much more. I have been somewhat close to several attempts to close the loopholes, not only the 1969 attempt but also—

Chairman PROXMIRE. Just to interrupt, isn't it true the income tax has been reduced something like six times in the past few years?

Mr. HOUTHAKKER. It has been reduced but I think the yield has not necessarily gone down as much. I think what we had under the very high rates prevailing before 1964 is that the high rates just weren't very effective. People found all sorts of ways around them, so I think it may well be if we would make a study what the tax reductions actually did, it was not a proportionate reduction in revenue. The rates went down but the revenue probably did not go down as much.

Now, this makes me think that the prospects for a significant increase in revenue from the individual and corporate income taxes are not very great and if I am right in fearing that expenditures will continue to go up, then we do have to find another source of revenue at some point, and that, I think, is basically the case for the value-added tax. It is not that it is a good tax but somehow or other we have to find some more revenues.

I have a lot of sympathy with the ideas put forward by George Break just now about alternatives, but there again I don't see them enacted right now.

Chairman PROXMIRE. You have in mind eliminating many of the tax subsidies that are identified in the staff study?

Mr. HOUTHAKKER. I would certainly be in favor of eliminating quite a few of them, not necessarily all of them, because I don't agree on one or two items. But I think that there is some work to be done there very definitely.

I also think that closing loopholes is important to maintain taxpayer compliance because if people see somebody else get away with not paying tax at a high income then he is not going to be conscientious either; so I think the case for tax reform is always there but, on the other hand, the experience throughout the 1960's leads one to suspect that progress will be very limited and not enough to make up the very large shortfall in revenue that we are facing. That, I think, is essentially the case for the value-added tax.

I should add to this that I don't give any weight at all to the argument that the value-added tax would somehow increase our competitive position. I think that is a completely fallacious argument. If there is a case for a value-added tax, it is only that it will bring in more revenue.

Chairman PROXMIRE. Well, gentlemen, I want to thank you for an excellent job. You have gotten our hearings off to a very fine start and I do think these hearings are historical. I think they will have real significance. I certainly hope so and if they do have, a great deal of the responsibility for it will be because of your very fine testimony, the excellent record that you made here this morning.

Tomorrow, on Friday, we will meet in this room to hear Ben Okner, economist, Brookings Institution; Joseph Pechman, director, economic studies program, Brookings; Stanley Surrey, professor of law at Harvard University; and also Phil Stern, author of "The Great Treasury Raid," who has some very ingenious and provocative testimony.

Thank you very much.

(Whereupon, at 12:20 p.m., the subcommittee was adjourned, to reconvene at 10 a.m., Friday, January 14, 1972.)

# THE ECONOMICS OF FEDERAL SUBSIDY PROGRAMS

FRIDAY, JANUARY 14, 1972

CONGRESS OF THE UNITED STATES,  
SUBCOMMITTEE ON PRIORITIES AND  
ECONOMY IN GOVERNMENT OF THE  
JOINT ECONOMIC COMMITTEE,  
*Washington, D.C.*

The subcommittee met, pursuant to recess, at 10 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire; and Representatives Reuss and Blackburn.

Also present: John R. Stark, executive director; Lucy A. Falcone and Jerry J. Jasinowski, research economists; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, economist for the minority.

## OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. Today is the second day of our hearings on the Federal subsidy system, one of the most complicated, controversial and neglected areas of economic activity. We are investigating this area because subsidies have become an incredibly pervasive influence on the private economy, yet they are often hidden, poorly understood, and rarely evaluated.

Mr. Carl Shoup referred to subsidies as "the great fiscal unknown" and the other two witnesses, Mr. Break and Mr. Houthakker—this was yesterday—were in complete agreement on that point.

Yesterday's three witnesses also agreed that the subsidy system is out of control and in great need of an in-depth review and analysis. All three agreed that every effort should be made to reform the budget so that the cost of Federal subsidies is identified. Mr. Shoup recommended a Subsidy Monitoring Board and Mr. Houthakker a Joint Congressional Committee, that is, House and Senate, on Special Benefits. All three of the witnesses agreed that such a review mechanism should be made a legislative requirement similar to the West German biannual subsidy report.

So yesterday we had excellent testimony that will be most useful in laying the groundwork for a more careful study of the mammoth subsidy system.

Today we wish to expand this base and give particular attention to tax subsidies. Of the \$63 billion total identified in the staff study, over half, \$38 billion, is accounted for by tax subsidies and this is a conservative estimate. As a matter of fact, I noticed that the Pechman-Okner study estimates a far, far larger amount. The staff study ex-

cluded and labeled as welfare payments over \$10 billion of special tax preferences designed to aid low-income individuals. How many other tax subsidies or special tax benefits exist, we do not know.

Still, at least \$38 billion in the tax subsidies amounts to more than \$700 per year for every family in the Nation.

What do these tax subsidies do for the economy and for the average citizen? They appear designed to stimulate the purchase of machinery by business, encourage military service, buy railroad cars, encourage homeownership, accelerate the use of certain natural resources, encourage firms and individuals to locate abroad and to aid small business, credit unions, banks and life insurance companies. But, in fact, amazing as it may seem, we don't really know what effect these tax subsidies have on the allocation of resources in this country.

Just as important, perhaps in some cases more important, is the question of who gets the benefits from our special tax provisions. Do housing tax subsidies go to the rich or to the poor? Are the benefits of capital gains widely disbursed in the economy or are they a boon to the rich? Of what benefit are the international tax subsidies to the average man? The American people have a right to know who benefits from these special benefits.

We have not been able to answer these questions because there has been poor accounting and analysis of tax subsidies and benefits to date. In 1967, Stanley Surrey, who has done yeoman work on the problem, said, and I quote:

In the absence of special studies the amounts involved are simply unobtainable. Indeed, many of these tax expenditure programs cannot be found in the Internal Revenue Code, so that, unlike direct expenditure programs, where the budget trails are relatively well posted, the tax-expenditure trails are very often obscurely marked.

As far as I can tell the past 4 years have brought no improvement in this sad state of affairs. We still do not have a regularly published accounting of these special tax provisions and the public simply does not know much about them.

To assist the subcommittee in understanding this complex tax area we have commissioned 10 study papers in our study series of 40 papers.

Our first three witnesses—we will hear from Philip Stern a little later—but our first three witnesses, Mr. Surrey, Mr. Pechman, and Mr. Okner, will be testifying on the basis of studies they have prepared for the Joint Economic Committee and which will be published subsequent to the hearings.

Our first witness will be Mr. Surrey.

Mr. Stanley Surrey has taught at the California School of Law, Columbia University Law School, and since 1958 has been professor of law at Harvard University Law School. From 1948 to 1961 he was Director of the American Law Institute program in taxation. From 1961 to 1968 Mr. Surrey served as Assistant Secretary of the Treasury for Tax Policy where he pioneered work on the tax expenditure budget, from which any subsidy analysis must draw. No one is more expert than he on the inequities and weaknesses in our tax laws and the difficulty, in view of the political clout of those who benefit from inequities, in getting any improvement in our tax laws. Mr. Surrey has testified for this committee before and it is a pleasure to welcome him back.

Mr. Surrey, go ahead.



**STATEMENT OF STANLEY S. SURREY, PROFESSOR OF LAW,  
HARVARD UNIVERSITY**

Mr. SURREY. Thank you, Mr. Chairman. I appreciate being here as part of the extremely important study which this committee is conducting.

My role today is to talk generally about the subject of tax subsidies as a device for implementing Government policy.

As the chairman has stated, the Federal income tax is replete with tax subsidy provisions.

Perhaps little noticed is the fact that since 1969 the list of these tax subsidies has grown considerably larger.

Chairman PROXMIER. Could I just interrupt, Mr. Surrey, to say that your entire prepared statement will be printed in full in the record, including the very helpful tables that you have at the end, and we would appreciate it if you could abbreviate your prepared statement.

Mr. SURREY. Yes, that is what I am going to do, Mr. Chairman.

Chairman PROXMIER. Fine.

Mr. SURREY. Since 1969 the list of these tax subsidies has grown larger, with both the Treasury Department itself, forces within the Congress, and outside groups pushing still more tax subsidies into the system.

If one looks at the 1971 Revenue Act, the major part of that act, both as to revenue and space, involves the subject of tax subsidies; and it is interesting to see what were the things done by that act.

That act brought about the restoration of the 7 percent investment credit; a class life system for depreciation of machinery and equipment; a preferential treatment of income from exporting; 5-year amortization for the construction of facilities for employer on-the-job training programs and child care facilities; a large increase in the child care deduction; a tax credit to employers who employ persons certified by the Secretary of Labor; and a tax credit and deduction for political campaign contributions. All of these are expenditure programs put into the tax system, and they indicate the extent to which the 1971 act was influenced by the subject of tax subsidies.

One should note that the Conference Committee on that bill rejected the following Senate-passed subsidies: A system of credits and rebates for secondary school education; a tax credit for elderly people for property taxes; an extra personal exemption for disabled persons; and a credit for investment for rural or central city job development.

So the 1971 act, the latest act in the tax field by Congress, was completely dominated by the aspect of tax subsidies.

I don't think it is a coincidental result but I think it is a direct result of the influence of these subsidies that this act is one of the least creditable revenue measures in many a decade and one that considerably weakens the fairness and structure of the income tax.

Less critical analysis is paid to these tax subsidies than almost any direct program that the Congress considers. These tax subsidies simply tumbled into the law without any supporting studies; they are propelled by cliches, debating points, and scraps of data that are passed off as serious evidence. A tax system that is so vulnerable to this injection of extraneous, costly, and ill-considered expenditure programs is simply in a very precarious state from the standpoint of the basic goals of tax fairness.

If you look at the tax system in this light, you see it really consists of two parts: one part is the provisions of the tax law that are necessary to have an income tax. In other words, the United States has decided to have an income tax. If you are going to have an income tax you need certain provisions to run an income tax. You have to measure income and the like, and that is the income tax system of the United States.

But then engrafted on to this system is a vast expenditure program which, the chairman has indicated, has nothing to do with an income tax; it is just a method of handing out money which has been engrafted on and placed into the tax system. Consequently, when you look at the tax system you always have to understand it constitutes these two parts: that necessary to levy an income tax in the United States and that which is carrying out these various expenditure programs.

I have included at the end of my prepared statement a tax expenditure budget, which is an effort to list those parts of the tax system that have nothing to do with the fact that the country has an income tax but have everything to do with the fact that we are running an expenditure program through the tax system. This table, which is based upon a Treasury table published in 1969 and 1970, lists these tax expenditures by budget categories. They are the ones that the chairman has indicated.

You can go through every budget category practically and see that for that category of the budget, in addition to budget expenditures, there are these expenditures run through the tax system.

But you won't find this listing except in rather obscure places within the Government. You will never find it in the budget and, consequently, it is one of these hidden things that the chairman was mentioning.

Now, given this tax expenditure budget, of what use can it be to us?

Again, as I indicated, it enables us to look at the income tax provisions in a new light. Once you see that the items mentioned in the tax expenditure budget have nothing to do with the Federal income tax but only have to do with expenditure programs, then you can treat them as traditional expenditure items and you can ask the question that a Congressman normally asks in dealing with an expenditure program: Do we want the program? Do we want to give people the assistance that this program provides? Is the program properly structured? What will it do? Will we get back what we want for the costs and so forth. You can put these traditional budget questions to each of these expenditure programs.

There is one preliminary step, however, that is highly important and that is that since a tax expenditure program is written in tax terms it is necessary to translate the tax provision into expenditure language that people can understand. Since the expenditure and the assistance are made through the tax provisions, the way they work out depends upon the particular tax status of the individual or corporation benefited. It depends upon what tax bracket an individual is in. It depends upon whether people are taxpayers or not, because any expenditure system that is run through the tax law does not give any help to people who are not taxpayers.

It only gives help to people who are taxpayers. That automatically cuts out a large proportion of the population from any benefits. It does not give any help to corporations that are losing money. It only gives help to corporations that are making money. It does not give help to public bodies because they are not taxpayers. So, consequently, you have to translate the tax expenditure provision out of its tax terms and into expenditure terms.

For example, in this tax expenditure budget you find a listing of assistance for housing, owner-occupied housing, through the deduction of property taxes and mortgage interest. How do you translate that tax deduction of mortgage interest and property taxes to assist homeowners into an expenditure program?

Well, the translation first tells us that since this program is phrased in terms of deduction from income it means the wealthier the individual the higher his benefits, because the deduction comes off of the top bracket of income and that is the first step in the translation.

A deduction of \$100 in mortgage interest is worth \$70 to a taxpayer in the top bracket; it is worth \$14 to a taxpayer in the first bracket. As a consequence of this translation, you learn that about 70 percent of the over \$5 billion of assistance through the tax system to owner-occupied homes goes to individuals with incomes of over \$10,000. It is a funny housing program that does that.

The translation next tells us that an individual or family whose income is so low that they do not pay any taxes get no assistance whatever from this program. It also tells us that there is no limit placed on the size or value or number of houses for which benefits can be given. You get a benefit for your residence, summer residence, winter residence, as many residences as you want.

What is the nature of the housing program? Let's suppose one would take this translation and envision an expenditure program that would be constructed to parallel the results of the tax system. It would then be the same as if HUD came up to the Congress and said, "We have a program to assist people who own homes and this is our program. If there is a married couple with more than \$200,000 of income why for each \$100 of mortgage that they have, HUD will pay that couple \$70. On the other hand, if there is a married couple with an income of \$10,000, then under this HUD program we will pay that married couple only \$19 on their \$100 mortgage interest bill. And, of course, if they are too poor to pay an income tax then we are not going to pay them anything under our owner-occupied home assistance program."

It is quite obvious no HUD Secretary would come up with a program as outrageous as this, and yet that is the tax assistance program that we have for owner-occupied homes.

Other illustrations exist and, in fact, almost any of these tax subsidies will be seen as upside down and unfair programs if you translate them into direct expenditure terms.

For example, in 1969 Congress passed the tax incentive for the rehabilitation of low-income housing. It provided 5-year amortization of expenditures for low-income housing.

But suppose you translate that into some comparable terms. Well, for a taxpayer in the 70-percent bracket that is just the same as if

you enacted a 19-percent investment credit for that taxpayer for investment invested in rehabilitated housing. But it happens to be a 5-percent credit for a taxpayer in the 20-percent bracket.

You can look at it another way. Suppose HUD came up and said, "We want to make it easier to rehabilitate houses and we are going to give people who borrow for that purpose a subsidy on their interest." The program that HUD would be recommending, that would be parallel to what is in the tax system, is that if a 70-percent taxpayer borrows to rehabilitate houses at an 8-percent interest rate, HUD will subsidize the loan so that it becomes a 3-percent rate of interest. On the other hand, if a person in the first bracket, 20-percent bracket, borrows the money at 8-percent interest, HUD is only going to subsidize 1 percent of that interest rate, leaving the net interest at 7 percent. This is a completely upside down program.

It is tax incentives like this rehabilitation provision that produce the "tax shelters" that we hear about and are being marketed by investment houses for upper-bracket taxpayers. These tax shelters, through fast writeoffs for investment in low-income housing, oil drilling, leasing of equipment and farming, are responsible for the cases that Congressman Reuss and others have indicated in which individuals pay little or no income tax.

These tax shelters are also as inefficient as they are unfair. For example, the tax benefits that are given for investment in low-income housing result in the Treasury paying an investor \$1 so that the developer of that housing gets 75 cents. In other words, the Treasury is paying a 140-percent commission to investors in low-income housing in order that developers can have some profit in putting up these houses.

Commissions of 140 percent and 150 percent are not unusual in this tax subsidy world. You can see that I am translating the benefits into a commission. There the Treasury pays \$1 in tax benefits to a top bracket taxpayer who buys a tax exempt bond in order that a State may save 75 cents in interest costs. This is a 133-percent commission to a person in the top bracket who buys a tax-exempt bond. This is both an unfair program and a complete waste of Government money.

These unfairnesses cannot be escaped when the tax system is being used to provide the financial assistance.

Take, for example, the provision in the 1971 act of deduction or credit for political contributions. You get a deduction of \$100 or a tax credit of \$25 if you contribute to political candidates. But this tax credit program means, if you translate it into expenditure terms, that if a taxpayer sends \$25 to a candidate, the Government will send \$25 to the candidate. But that system, since it is phrased under the tax law, has the effect of cutting out from the government matching about 30 percent of the electorate which does not pay any income tax. If any of those people make a contribution, the Government refuses to match that contribution; it only matches contributions of people who can afford to be taxpayers in the United States.

You get the same system with respect to the deduction for charitable contributions. Let's take the deduction for charitable contributions and translate it into an expenditure program that would have the same result as the system that operates under the tax law today. That would have an HEW Secretary coming to the Congress and saying, "We want

to assist philanthropic institutions in the United States and we propose to establish a Division of Charitable and Educational Assistance which will distribute its funds as follows: Supposing a person calls and says 'I am too poor to pay an income tax but I am able to contribute \$15 to my church or other charity.' Will the Government help this institution?"

The answer that HEW would give in this case is "We appreciate your sacrifice, but we cannot use our funds in this situation."

Under this program, however, suppose a person calls and says, "I am quite well off and I want to send a check for \$3,000 to one of my favorite charities; will the Government also aid this charity?" The answer under the HEW program will be, "We are delighted to be of assistance and we are at once sending a Government check of \$7,000 to this charity."

Supposing another person calls and says, "I am really very wealthy with a considerable fortune in various stocks which originally cost me and my family very little; in fact, I will be selling about \$2 million of stock to pay my income tax this year and to raise cash for other purposes. I think that a particular charitable institution deserves support and while I have decided not to contribute anything myself, I am calling to ask whether the Government will contribute to this charity."

The answer here will be, "We understand the situation and we will be delighted to contribute \$2 million to this charity. We will, of course, say it is in your name and in appreciation of your suggesting this to us, we are sending you a check for \$100,000, tax exempt, of course."

Now, this parallels the present treatment of charitable contributions. This is the program that Congress would have if it decided to parallel the tax subsidies for philanthropic institutions. This reflects the tax expenditure approach but I doubt if anyone ever designed the tax system to consciously operate in this way; it is the way it has grown up.

What do you do about it? What do you do about this tax expenditure budget? The fact that we know we are now dealing not with provisions necessary to the income tax but we are dealing with expenditure programs enables us to go through this tax expenditure budget and say, "Does the Government of the United States want to spend money for these purposes?" You can simply go through this budget, this list of tax expenditures, and ask: "Which of these tax programs can be dropped without any substitute direct expenditure program?"

In other words, which tax expenditures are simply unnecessary? Which do not involve Government needs or priorities that must be met? Which programs would you like to keep? What are the areas in which you want to provide financial assistance, but which can readily be changed from a tax program to a direct program? Which matters do you want to keep but which can't be readily changed so that it may be more difficult to devise a regular program for? And which do you want to keep and you think, all things being considered, the best way of providing the assistance in the end is through the tax system?

It seems to me under this approach people should be put to the burden of proof to say that they need the assistance, that is, in this tax expenditure budget. I think if you went through the budget in those terms and asked people and industries to say that the assistance we are getting here is a matter of national priority, the Government should

pay out money for these purposes, a great many of these programs would simply disappear. The Government would not want to give any assistance in these areas.

In a number of other cases, I think the Government would want to continue the assistance. I think the Government will want to continue assistance to owner-occupied homes which I mentioned, so that there the problem would be to devise a direct expenditure to the extent that you wanted to give assistance, take the provision out of the tax law and provide the money simply through a regular program of HUD in this area. That could be done, I think, in most of these cases.

There would be some cases, however, in which it is not so easy to devise direct programs because the tax mechanism does provide certain things that I think probably Congress would want to build into any direct program. One example is State and local bonds. It seems to me that the essence of the present tax assistance is that the Federal Government does not have any control over that subsidy; it is given to any State or any locality that simply wants to issue a bond. My guess is that Congress will want that aspect to be preserved, that freedom of operation by the State. Hence, you have to find a direct subsidy program that permits that freedom. That, I think, can be readily found in simply letting the States issue a taxable bond and the Federal Government subsidizing part of the interest on any such taxable bond.

So, consequently, in a few areas, it would be necessary to devise special programs. The program of assistance to low-income housing which provides this tax shelter for investors I think could be replaced by a direct payment to developers of low-income property, because all the Government is doing today is to pay money to the investor so he will give money to the developer. We should be able to eliminate that middleman as unnecessary.

On conclusion, I think the pathway to reform of the income tax is through the reform of this tax expenditure program.

What is needed is research in some areas, the exercise of responsibility by the administrative agencies involved in other areas, leadership by the Office of the Budget and Management and the Treasurer, and political will to reform on the part of legislators.

Thank you.

(The prepared statement of Mr. Surrey follows:)

PREPARED STATEMENT OF STANLEY S. SURREY

TAX SUBSIDIES AS A DEVICE FOR IMPLEMENTING GOVERNMENT POLICY:  
A COMPARISON WITH DIRECT GOVERNMENT EXPENDITURES

The present federal income tax is replete with tax subsidy provisions. Some were adopted to assist particular industries, business activities, or financial transactions. Others were adopted to encourage nonbusiness activities considered socially useful, such as contributions to charity. Moreover, suggestions are constantly being made that many of our pressing national problems can be solved, or partially met, through the use of income tax subsidies.

Since 1969 the list of these tax subsidies has grown larger with both the Treasury Department itself, forces within the Congress, and outside groups pushing new subsidies into the tax system. The major part of the permanent changes in the income tax provided by the 1971 Act—both as to revenue and space in the tax law—involved new subsidies.

Thus, the 1971 Act introduced the following income tax subsidies: restoration of the 7% investment credit; a class life system for depreciation of machinery and equipment, currently based on the use of the thirtieth percentile experience

as of 1962 (starting at the shorter pole), abandonment of a reserve ratio test requiring attention to a taxpayer's own experience, and with permission to the Treasury to grant a 20% shorter class life; a preferential treatment of income from exporting (DISC), which in practical operation will exempt one-half of that income from tax; five-year amortization for the construction of facilities for employer on-the-job training programs and child care facilities; a large increase in the child care deduction, including household expenses; a tax credit to employers who employ persons certified by the Secretary of Labor as having been placed in employment under work incentive programs (WIN); a tax credit and deduction for political campaign contributions. It should be added, to indicate the extent to which the 1971 bill involved tax subsidies, that the Conference Committee on that bill rejected the following Senate passed subsidies: a system of credits and rebates for post-secondary school education; a tax credit for elderly persons for property taxes on their residences or rent constituting property taxes; an extra personal exemption for disabled persons; a 10% credit for investments in rural or central city job development assets.

The 1971 tax legislation was thus dominated by the aspect of tax subsidies. It is not a coincidental but a direct result of this influence that the 1971 Tax Act is one of the least creditable revenue measures in many a decade and one that considerably weakens the fairness and structure of the income tax.

It can generally be said that less critical analysis is paid to these tax subsidies than to almost any direct expenditure program one can mention. The tax subsidies tumble into the law without supporting studies, being propelled instead by clichés, debating points, and scraps of data and tables that are passed off as serious evidence. A tax system that is so vulnerable to this injection of extraneous, costly, and ill-considered expenditure programs is in a precarious state from the standpoint of the basic tax goals of providing adequate revenues and maintaining tax equity. It is therefore imperative that the process and substance of these tax subsidies be reexamined.

#### I. THE NATURE AND EXTENT OF EXISTING TAX SUBSIDIES—THE TAX EXPENDITURE BUDGET

##### A. *The tax expenditure budget*

The Federal Income tax system consists really of two parts: one part comprises the structural provisions necessary to implement the income tax on individual and corporate net income; the second part comprises a system of tax expenditures under which governmental financial assistance programs are carried out through special tax provisions rather than through direct government expenditures. The second system is simply grafted on to the structure of the income tax proper; it has no basic relation to that structure and is not necessary to its operation.

Instead, the system of tax expenditures provides a vast subsidy apparatus that uses the mechanics of the income tax as the method of paying the subsidies. The special provisions under which this subsidy apparatus functions take a variety of forms, covering exclusions from income, exemptions, deductions, credits against tax, preferential rates of tax, and deferrals of tax. The Tax Expenditure Budget, included herein as Table 1, identifies and quantifies the existing tax expenditures. This Tax Expenditure Budget is essentially an enumeration of the present "tax incentives" or "tax subsidies" contained in our income tax system.

The list of these tax expenditures here used for the purposes of discussion is based on that drawn by the Treasury for the fiscal year 1969, but brought up to date. The items printed in bold italics were additions made by the 1969 Reform Act, and the items printed in bold face type were added by the 1971 act. The estimates are generally at 1971 levels, with various asterisks indicating reductions and increases. These notations are explained briefly in a footnote. These tax expenditures include both tax subsidies (or tax incentives) and individual welfare items (such as old age assistance).

The items in this Tax Expenditure Budget total between \$55 to \$60 billion—equal to one-fourth of the regular budget. Yet most of these items seem almost to live a life of their own, undisturbed and unexamined. No agency studies or controls them. The Budget Bureau neglects them, for the items are not in its Budget. The executive departments likewise are not concerned, for the items are not in their program. The Treasury is apparently not evaluating them, but rather is adding new and indefensible items. This is clearly no way to run a tax system and no way to run a budget policy.

### *B. Some uses of the tax expenditure budget*

I turn now from the Tax Expenditure Budget itself to the uses to which such a budget may be put. For what purposes of tax policy is it a useful tool? For what purposes of expenditure policy is it a useful tool? What questions does it help us to formulate and ask? What questions does it help us to answer?

The Tax Expenditure Budget enables us to look at the income tax provisions reflected in that Budget in a new light. Once these tax provisions are seen not as inherent parts of an income tax structure but as carrying out programs of financial assistance for particular groups and activities, a number of questions immediately come into focus. Once we see that we are not evaluating technical tax provisions but rather expenditure programs, we are able to ask the traditional questions and use the analytical tools that make up the intellectual apparatus of expenditure experts.

We thus can put the basic question of whether we desire to provide that financial assistance at all, and if so in what amount—a stock question any budget expert would normally ask of any item in the regular Budget. We can inquire whether the program is working well, how its benefits compare with its costs, is it accomplishing its objectives—indeed, what are its objectives? Who is actually being assisted by the program and is that assistance too much or too little? Again, these are stock questions directed by any budget expert at existing programs. They all equally must be asked of the items and programs in the Tax Expenditure Budget.

The fact that the Tax Expenditure Budget summarizes an “expenditure system described in tax language” adds, however, a new dimension to these traditional questions. Each program in that Budget is carried out through a special tax provision. The financial assistance which the program grants is thus determined through the effect of that special provision on the tax liabilities of the persons benefitted. And also, since the persons benefitted are only those within the ambit of the income tax system, the program’s assistance is confined to taxpayers and does not extend to non-taxpayers. Individuals whose income amounts are below personal exemption levels, businesses that are losing money rather than making profits, organizations that are tax exempt, being non-taxpayers they do not receive the assistance. As a consequence, before we analyze the tax expenditure program, we must first translate the tax language into expenditure results.

Thus, consider the tax expenditure program for housing represented by the deductibility of mortgage interest and property taxes paid on owner-occupied homes, listed as an item under Community Development and Housing. This is a program of assistance estimated at about \$5.7 billion (fiscal 1971). The translation of the tax language in which the program is framed and the assistance provided—a *deduction* in computing taxable income—tells us first that the wealthier the individual the greater is his assistance under the program. This is because the higher the individual’s income and thus the higher the individual’s income tax rate, the larger is the tax benefit—the tax reduction—brought about by the deduction. A deduction of \$100 in mortgage interest or \$100 in property tax is “worth” \$70 to a taxpayer in the 70% top bracket—i.e. is financial assistance of \$70. But it is “worth” only \$14 to a taxpayer in the first bracket of 14%. As a consequence of this method of providing assistance, about 70% of the \$5.7 billion of this financial assistance for owner-occupied homes goes to individuals with incomes of over \$10,000. The translation next tells us that an individual or family whose income is so low that they are not required to pay an income tax—their income being below their personal exemptions and low income allowances—does not receive any financial assistance, for deductions benefit only taxpayers and not non-taxpayers. The translation also tells us that there is no limit placed on the size or value of the homes to be assisted nor on the number of residences for which a taxpayer may receive assistance, for the deduction is simply in terms of mortgage interest and property taxes paid.

The process of translation thus gives us the contours of the tax expenditure program for housing—contours that are quite different from the housing assistance programs formulated in direct expenditure terms. But the contrast—and hence the nature of the task of analysis in expenditure terms—can only be appreciated after the translation is made. It is only then that we can really ask the crucial question of how does this tax expenditure program measure up as an “expenditure” program. For then we can restate the tax program as a direct



expenditure program and ask whether such a program represents a desirable policy.

The translation and consequent restatement of a tax expenditure program in direct expenditure terms generally show an upside-down result utterly at variance with usual expenditure policies. Thus, if cast in direct expenditure language, the present assistance for owner-occupied homes under the tax deductions for mortgage interest and property taxes would look as follows, envisioned as a HUD program :

For a married couple with more than \$200,000 in income, HUD would, for each \$100 of mortgage interest on the couple's home, pay \$70 to the bank holding the mortgage, leaving the couple to pay \$30. It would also pay a similar portion of the couple's property tax to the State or city levying the tax.

For a married couple with income of \$10,000, HUD would pay the bank on the couple's mortgage \$19 per each \$100 interest unit, with the couple paying \$81. It would also pay a similar portion of the couple's property tax to the State or city levying the tax.

For a married couple too poor to pay an income tax, HUD would pay nothing to the bank, leaving the couple to pay the entire interest cost. The couple would also have to pay the entire property tax.

One can assume that no HUD Secretary would ever have presented to Congress a direct housing program with this upside-down effect.

Other illustrations exist—in fact almost any of these tax subsidies is seen as woefully unfair or inefficient when cast as a direct expenditure program. Thus, the 1969 tax legislation contained a tax incentive for the rehabilitation of low income housing, using the device of five-year amortization of capital expenditures which otherwise would be depreciated over a longer period. This device, which was proposed by the Treasury Department, has these interesting effects for individual taxpayers: for a taxpayer in the 70% bracket, the benefit is the equivalent of a 19% investment credit (assuming an expenditure with a 20-year life and discount rate of 10%); for a taxpayer in the 20% bracket it is the equivalent of a 5% credit. In terms of interest costs on a loan made for rehabilitation purposes, the benefit of five-year amortization is equivalent for the 70% bracket taxpayer to reducing an 8% interest charge to 3%; for the 20% bracket taxpayer it is equivalent to reducing the 8% charge to 7%. Besides having this upside-down effect, the rehabilitation incentive is probably a waste of government money all around. It is not likely to increase the amount of rehabilitated housing over what would be accomplished through the existing HUD direct subsidy alone, so that the tax incentive will just make some wealthy people more wealthy.

It is tax incentives like this rehabilitation provision that produce the various "tax shelters" being marketed by investment houses for upper-bracket individuals. These tax shelters—through fast tax write-offs for investment in low income housing, oil drilling, leasing of equipment, and farming—are responsible for many of the cases in which these individuals pay little or no income tax.

The tax shelters are as inefficient as they are unfair. Thus, the tax benefits for investment in low-income housing result in the Treasury's paying the investor \$1 in tax benefits so that he will in turn pay the developer seventy cents—a 140% commission. But generous commissions paid by the Treasury are not unusual in this tax subsidy world. The Treasury also pays \$1 in tax benefits to a top-bracket taxpayer who buys a tax exempt bond so that he will pass along seventy-five cents in interest rate benefits to the state or city issuing the bond—a 133% commission.

These unfairnesses and inefficiencies cannot be escaped when the tax system is being used to pay the financial assistance provided by the Government. A recent example is the 1971 Act provision for political contributions. The \$100 deduction (on a joint return) for political contributions, or alternative tax credit of one-half of the contribution up to a maximum credit of \$25 (on a joint return), added in 1971, in effect bars individuals below the taxable levels from participating in the allocation of government funds to their candidates. Thus, the credit approach in effect means that if a taxpayer sends \$25 to a candidate, then the government will also send \$25 to the candidate—the effect of allowing a tax credit of \$25 for a contribution of \$50. But if individuals below these taxable levels—perhaps 25% to 30% of the electorate—contribute any money, the government refuses to match those funds.

The deduction for charitable contributions, the tax device used to provide Government assistance to philanthropy, is another example. This deduction translated into direct expenditure terms would look like this, envisioned as an HEW program:

We propose to establish a Division of Charitable and Educational Assistance which will distribute its funds as follows:

Suppose a person calls and says: "I am too poor to pay an income tax but I am contributing \$15 to my favorite charity. Will the Government also help it?" The answer here will be: "We appreciate your sacrifice but we cannot use our funds in this situation."

Suppose a person calls and says: "I am quite well-off and want to send a check for \$3000 to one of my favorite charities. Will the Government also aid it?" The answer here will be: "We are delighted to be of assistance and are at once sending a Government check for \$7000 to that charity."

Suppose a person calls and says: "I am really very wealthy with a considerable fortune in various stocks that originally cost me or my family very little. In fact, I will be selling about \$2 million of stock to pay my income tax this year and to raise cash for other purposes as well. I think that a particular charitable institution deserves support and while I have decided not to contribute anything myself, I am calling to inquire whether the Government will contribute to it." The answer here will be: "We understand the situation and will be delighted to contribute \$2 million to that institution. We will of course say it is in your name. And, in appreciation of your suggesting this to us, we are sending you a check for \$100,000, tax-exempt of course."

Finally, if a person makes application to the Office for Private Foundations and says he is establishing a foundation which he will direct and manage, with the advice of his wife and one or two friends, and is contributing, say, \$1 million in cash to it, then the Government will send him funds in the amount of \$2 $\frac{1}{2}$  million to be placed in the foundation, also under his control. (We have discontinued the system under which if the person paid his income tax or obtained cash for other purposes by selling appreciated stock, we would fund the entire foundation for him and then give him a payment, itself tax-exempt, for thinking of the idea.)

While this direct expenditure mechanism would mirror the tax expenditure approach, the latter was never consciously designed to operate in the manner that has emerged. Rather it grew up that way without the government or philanthropy really thinking through its implications.

This examination and translation of tax expenditure items would force the exploration of possible direct expenditure programs as alternatives to accomplish the same overall financial assistance goal. The exploration would seek to ascertain if such direct expenditure programs would be more desirable and effective vehicles for providing that assistance than the existing tax expenditure program. This process would probably be hastened if the tax expenditure items were placed in the regular Budget and the funds involved charged to the agencies having the prime responsibility for the program objectives represented by the items. An agency so charged with these tax expenditure funds in its "budget" might well be prompted to see if it liked the results and is willing to stand behind them, in contrast with the present attitude of indifference to the tax expenditure item or perhaps even ignorance of the item or its effects.

## II. THE VARIED APPROACHES NECESSARY TO REPLACE TAX EXPENDITURES WITH DIRECT GOVERNMENTAL ASSISTANCE

The fact that a tax expenditure program can be recast as a direct expenditure program really takes us to the heart of tax reform, for it opens up a new way to consider the entire subject. We can regard a major aspect of income tax reform as involving the re-examination of all of the tax expenditure provisions now contained in the income tax. We should start by examining the list of tax expenditures and seeking to decide which should go and which should remain. In a sense, that of course is what tax reformers have always done, whether they talked in terms of base broadening, elimination of preferences, or needed elimination of loopholes.

The tax expenditure analysis, however, really tells us why that traditional approach is not enough. The analysis helps us to understand why that approach can

deal with some problems but why it fails to reach others, as indeed it did as recently as 1969. For tax expenditure analysis conceives of the special provisions—the preferences and loopholes—as government financial assistance comparable to that contained directly in the Budget. So viewed, this aspect of tax reform becomes a review of budgetary programs.

The questions then become:

Which tax programs—which tax expenditures—which tax incentives—which special tax provisions—can simply be dropped without substituting another form of government assistance, because on review it is seen that government policies and priorities do not require the expenditure of federal funds for the purposes involved in these items?

Which tax programs cannot be simply dropped—because government policies and priorities do require the expenditure of federal funds for the purposes involved—but can be readily changed from tax expenditures to direct expenditures, in a way to achieve an improvement in equity and efficiency?

Which tax programs, in the group which cannot simply be dropped, would have to meet special criteria regarding the structure of the substituted direct expenditure program, so that a change must await the development of the latter program?

Finally, which tax programs function much more efficiently and effectively as tax expenditure programs than as direct expenditures so that any consequent loss in tax equity or strain on the tax structure must yield to the need for the use of the tax system in this special case to carry out a particular government policy?

An overall view of much of the task of tax reform, under this analysis, can therefore be obtained by examining the list of items in the Tax Expenditure Budget in the light of the questions posed earlier. A glance at the list and some general observations may here be helpful.

*First.*—A considerable number of items in the tax expenditure list might be dropped without substituting any alternative program of financial assistance from the government. The additional revenue so obtained could be used for rate reduction, for other tax reduction purposes, or for budgetary purposes. In most of these instances tax history has resulted in a tax expenditure for a group or activity that has no present claim for such governmental assistance. Current budgetary priorities and policies would simply leave the matter to the judgments of the private sector. For these items the pace of tax reform progress is largely measured in political terms.

There are, thus, a number of items as to which it would seem appropriate that the proponents for retention of the tax expenditures should be called upon to make the case for their continuance. Thus, they should be required to demonstrate that, as a matter of national priorities and policies, they should continue to receive financial assistance for the activities involved, and if so, assistance of the magnitude now obtained. I would suggest the following items in the Tax Expenditure Budget (Table 1) could be explored from this standpoint to see if they fall in this first category:

The items under *International Affairs and Finance*.

Farming under *Agriculture and Rural Development*.

The items under *Natural Resources*, except pollution control facilities and mine safety.

The items under *Commerce and Transportation*, except the investment credit, railroad rolling stock and perhaps buildings.

Sick pay, interest on life insurance savings, casualty losses, under *Income Security*.

Deduction of gasoline, personal property and similar taxes under *Aid to State and Local Government*.

This listing is based on the previous legislative consideration of these items, and the relevant legislative debates, which largely appear to indicate that other factors, and not a considered congressional judgment that financial assistance is needed, are responsible for their continued presence.

The important point as to these items, however, is that if financial assistance is considered necessary, the items would then generally seem to fall in the next category, encompassing programs where direct financial assistance can readily be structured. Thus, for example, if it is decided that elimination of tax expenditures for natural resources should be accompanied by government assistance in oil and mineral exploration, the direct programs can readily be devised. The same can be said for tax expenditures for farming. Nevertheless, in the 1969

debates on these items the degree of tax change appeared to turn on vote counting and not on the aspect of an alternative assistance program.

*Second.*—A number of tax expenditure items now provide financial assistance for activities as to which it is quite probable that the groups assisted could be expected to sustain the burden of demonstrating the appropriateness of financial assistance. However, analysis of the special tax provisions involved has demonstrated in a number of these situations serious inequities and inefficiencies in the use of the tax system to apply that assistance. Both tax and direct budgetary policy would thus appear to dictate a conversion of some or all of the funds involved from the "tax expenditure budget" to the regular budget. This could be accomplished by the concurrent removal of the special tax provision and the adoption of a direct expenditure program structured to provide whatever financial assistance is appropriate and in the form desired.

Any amounts not so converted would simply remain part of general revenue receipts. Tax reform would thus in this category encompass a double-sided program: removal of the special tax provision and simultaneous adoption of a direct expenditure program using the funds made available by the tax change. In the past, tax reform proposals have generally dealt only with the first aspect, and for this reason have been vulnerable to objections by those benefitted by the special tax provision that its continuance was vitally needed, as an incentive, subsidy, benefit, assistance, or whatever.

Nearly all of the remaining items in the tax expenditure list appear to fall in this category, with the exception of the few matters discussed later. We are here considering items in which the formulation of the direct expenditure program would in general not appear to be a difficult matter. Presumably straightforward grant or loan expenditure programs would usually be involved. In some cases somewhat comparable programs presently exist, though usually involving smaller amounts. The important task is to interest the administrative agency having cognizance of the particular field to concern itself with working out the direct expenditure program. It is really unfortunate that up to now these administrative agencies have largely left unexamined the tax expenditure items in their areas, allowing the tax funds to be spent without coordination with their own objectives and programs. In other cases, also unfortunately, they have uncritically joined the benefitted groups in defense of the tax programs.

*Third.*—The first two categories cover most of the items in the tax expenditure list. The few that remain appear to impose special requirements that must be incorporated into any alternative program of direct assistance, and thus to lift such programs out of the more usual run of federal assistance programs. In other words, the use of the tax system in these cases provides monetary assistance under criteria or circumstances which, if they must be duplicated in a direct program if it is to replace the tax expenditure, will necessitate some special structuring of that program.

We can here include the following:

Exemption of interest on state and local obligations and deductibility of various state and local taxes, under *Aid to State and Local Government*, where the task as to the obligations is to devise a direct subsidy that state and local governments will consider to possess sufficient automaticity and freedom from federal control. The use of a taxable bond issued by state and local governments on which a significant portion of the interest cost is automatically paid by the Federal government should here be a suitable approach.

Deduction of charitable and educational contributions, under *Income Security and Education and Manpower*, where the task is to devise a direct subsidy that continues private designation of the charitable donee and freedom from federal control. The thinking here is still in the initial stages, with some researchers exploring a system of direct matching grants.

Deduction and credit of political contributions, under *Election Process*, where the task is to devise either a direct subsidy that continues private designation of the political candidates, such as a matching system, or a system of direct government financing of political campaigns without reliance on private funds.

The tax assistance accorded to owner-occupied homes and rental housing, under *Community Development and Housing*, and perhaps to buildings, under *Commerce and Transportation*. As to owner-occupied housing, the task is to devise a direct subsidy that can replace, for those homeowners for whom assistance is proper, the present tax incentives of the deduction for mortgage interest and property taxes. As to rental housing, the task is to devise an additional

direct subsidy for low-income housing—perhaps a direct payment to the developer—to replace the present inefficient and overgenerous tax shelter that now exists through the deduction of accelerated depreciation for new housing, five-year amortization in the case of rehabilitated housing, and other real estate tax benefits. The research here seems to be gathering momentum and the problem could be solved if HUD and the Treasury would recognize their joint responsibilities for the solution.

In a special category, finally, we could probably place the 7% investment credit for machinery and equipment, under *Commerce and Transportation*. This is a tax subsidy of broad scope and high visibility, so that its purpose as an incentive is readily apparent. The more important task here is to develop the credit so that it can become a flexible economic tool to be used counter-cyclically to dampen business demand for credit and funds in a tight money period and to spur investment demand in a slack period. At the same time, care needs to be taken that the existence of this special credit does not become the continuing wedge for those urging the adoption of a whole flock of tax subsidies in other fields where the direct approach is clearly preferable. This has been its history in the past and while the necessary care was taken in the 60's, this so far has not been the case starting in 1969.

In conclusion, the pathways to reform of the present tax expenditure apparatus are reasonably clear. What is needed are research in some areas, the exercise of responsibility by the administrative agencies involved in other areas, leadership toward reform by the Office of Budget and Management and the Treasury Department, and political will to reform on the part of legislators.

TABLE 1.†—*Tax expenditures, fiscal year 1971 (by budget function)*

National defense:	
Exclusion of benefits and allowances to Armed Forces personnel -----	Millions \$500
International affairs and finance:	
Exemption for certain income earned abroad by U.S. citizens-----	40
Western Hemisphere trade corporations-----	50
Exclusion of gross-up on dividends of less-developed country corporations -----	55
Exclusion of controlled foreign subsidiaries-----	165
Exclusion of income earned in U.S. possessions-----	90
***Partial exemption of export income (DISC)-----	* 170
<b>Total -----</b>	<b>570</b>
Agriculture and rural development:	
*Farming: Expensing and capital gain treatment-----	820
Timber: capital gain treatment for certain income-----	130
<b>Total -----</b>	<b>950</b>
Natural resources:	
Expensing of exploration and development costs-----	325
*Excess of percentage over cost depletion-----	980
*Capital gains treatment of royalties on coal and iron ore-----	5
**5-year amortization of pollution control facilities in pre-1969 plants-----	* 120
**5-year amortization of coal mine safety equipment-----	* 1
<b>Total -----</b>	<b>1,431</b>
Commerce and transportation:	
***Investment credit-----	* 3,600
*Excess depreciation on buildings (other than rental housing) -----	500
Dividend exclusion-----	280
*Capital gains: Corporation (other than agriculture and natural resources) -----	425

TABLE 1.†—*Tax expenditures, fiscal year 1971 (by budget function)*—Continued

	<i>Millions</i>
<b>Education and manpower—Continued</b>	
Excess bad debt reserves of financial institutions.....	\$380
Exemption of credit unions.....	40
Deductibility of interest on consumer credit.....	1,700
Expensing of research and development expenditures.....	540
*\$25,000 surtax exemption.....	2,000
Deferral of tax on shipping companies.....	10
**5-year amortization of railroad rolling stock.....	105
***Class lives for depreciation—20 percent reduction.....	" 2,400
<b>Total</b> .....	<b>11,980</b>
<b>Community development and housing:</b>	
Deductibility of interest on mortgages on owner-occupied homes .....	2,800
Deductibility of property taxes on owner-occupied homes...	2,000
*Excess depreciation on rental housing.....	255
**5-year amortization of housing rehabilitation expenditures...	" 330
**Deferral of capital gain on sale to occupants of certain low-income housing.....	(1)
<b>Total</b> .....	<b>6,285</b>
<b>Income security:</b>	
Disability insurance benefits.....	130
**Provisions relating to aged, blind and disabled:	
Combined cost for additional exemption for aged, retirement income credit, and exclusion of social security payments .....	2,950
**Additional exemption for blind.....	10
"Sick pay" exclusion.....	105
Exclusion of unemployment insurance benefits.....	400
Exclusion of workmen's compensation benefits.....	210
Exclusion of public assistance benefits.....	50
Treatment of pension plans:	
Plans for employees.....	3,075
Plans for self-employed persons.....	175
Exclusion of other employee benefits:	
Premiums on group term life insurance.....	440
Deductibility of accident and death benefits.....	25
Privately financed supplementary unemployment benefits....	20
Meals and lodging.....	170
Exclusion of interest on life insurance savings.....	1,050
*Deductibility of charitable contributions (other than education) .....	3,550
***Deductibility of child and dependent care and household expenses .....	" 145
Deductibility of casualty losses.....	80
**Standard deduction.....	3,000
**** Total .....	<b>15,585</b>
<b>Health:</b>	
Deductibility of medical expenses.....	1,700
Exclusion of medical insurance premiums and medical care...	1,450
<b>Total</b> .....	<b>3,150</b>
<b>Education and manpower:</b>	
**Additional personal exemption for students.....	500
*Deductibility of contributions to educational institutions....	200
Exclusion of scholarships and fellowships.....	60
***5-year amortization of employer child care and on-the-job training facilities.....	(1)

† Not available.

TABLE 1.†—*Tax expenditures, fiscal year 1971 (by budget function)*—Continued

Commerce and transportation—Continued	
***Credit for employment of public assistance recipients under WIN Program-----	<i>Millions</i> a \$25
Total -----	785
Veterans benefits and services:	
Exclusion of certain benefits-----	650
Aid to State and local governments:	
***Exemption of interest on State and local debt-----	2,300
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes)-----	5,600
Total -----	7,900
Election process:	
***Credit and deduction for political contributions-----	a 90
The 1968 Treasury table contained the following:	
*Capital gains—Individual income tax: Special provisions (increase in basis at death: exclusion of one-half of long-term gains: maximum tax rates of 25 percent on long-term gains) -----	5,500–8,500

<sup>1</sup> Not available.

(a) The estimates marked with (a) are for fiscal years other than 1971.

## NOTE

† *Source*: Statement of Hon. Murray L. Weidenbaum, Assistant Secretary of the Treasury, reprinted in Annual Report of The Secretary of the Treasury on the State of the Finances, Fiscal Year 1970, pages 306–308, and table in Cong. Record, S18764, Nov. 16, 1971 giving 1971 data.

An item listed under "Education and Manpower, that of educational expense deduction", \$40 million, is here omitted. It is understood that this item was included in error. The item refers to those expenses for education qualifying as trade or business expenses and hence allowable under the interpretation given to the general deduction for business expenses allowed under section 162 of the Internal Revenue Code.

*Explanation*: The items printed in bold italics were added by the 1969 Act. The items printed in bold type were added by the 1971 Act. The items marked with a single asterisk (\*) involve reductions under the 1969 Act, as explained below. The items marked with a double asterisk (\*\*) involve increases under the 1969 Act, as explained below. The items marked with a triple asterisk (\*\*\*) involve increases under the 1971 Act. The items marked with a quadruple asterisk (\*\*\*\*) involve decreases under the 1971 Act. The estimates marked with (a) are for fiscal years other than 1971, as explained below. (The above were not in the source table.)

The *single asterisk* items are explained below; the changes stem from the 1969 Act. The minimum tax on individuals and corporations affects a number of items, *i.e.*, those included as preferences, such as accelerated depreciation on buildings, capital gains, percentage depletion, stock option compensation, excess bad debt reserves and the five-year amortization provisions. But the overall effect is minor, with a revenue gain after transition of \$285 million from individuals and \$350 million from corporations.

*Farming*: A slight reduction in tax benefits will result.

*Percentage Depletion*: The percentage depletion rates have been reduced, for example, from 27½ to 22% for oil, with an estimated revenue increase of \$235 million.

*Depreciation on Buildings*: Accelerated depreciation on non-residential buildings has been lessened and recapture rules tightened, which should markedly reduce the table figure.

*Capital gains: Corporations*: The alternative rate on corporate capital gains has been increased to 30%, with a revenue increase, including agriculture and natural resources, of \$175 million.

*Excess Bad Debt Reserves:* Over a long transition period, the deductions for excess reserves of commercial banks are eliminated, and those for mutual savings banks and savings and loan associations materially reduced.

*\$25,000 surtax exemption:* Multiple surtax exemptions are eliminated over a transition period, with a revenue increase of \$235 million.

*Excess depreciation on rental housings:* Minor changes lessen accelerated depreciation on certain used residential housing and increase recapture on non-low income housing.

*Charitable Contributions:* The various changes do not affect the basic charitable deduction but do eliminate a number of abuses. The 1968 Treasury Table included "untaxed appreciation" on contributions in kind under charitable contributions, and also educational contributions, and this is apparently also true for the 1969 Treasury Table though not explicitly stated as in 1968.

*Educational Contributions:* The various changes do not affect the basic deduction for educational contributions but do eliminate a number of abuses.

*Capital Gains: Individuals:* The maximum rate on capital gains is increased to 35% (continues at 25% for aggregate gains up to \$50,000), with a revenue increase of \$275 million. A limitation on deduction of large amounts of interest incurred to carry investment assets has a minor effect, with a revenue increase of \$20 million. The estimate is for 1969.

The *double asterisk* items involve:

*New items:*

Pollution control facilities (estimate after transition ended).

Coal mine safety (estimate after transition ended).

Housing rehabilitation (estimate after transition ended).

Railroad rolling stock (estimate after transition ended).

*Existing items:*

*Additional exemption for aged:* The additional exemption is increased to \$750.

*Additional exemption for blind:* The additional exemption is increased to \$750.

*Standard Deduction:* The amount of the standard deduction is increased to 15%, or a maximum of \$2,000, with a revenue loss after transition of \$1.6 billion.

*Additional Personal Exemption for Students:* The additional personal exemption for students is increased to \$750.

The *triple asterisk* items involve:

*New items:*

*Restoration of investment credit, after repeal in 1969* (fiscal year 1973 estimate).

*Five-year amortization of employer on-the-job training and child care facilities* (no estimate given).

*Partial exemption of export income (DISC)* (fiscal year 1974 estimate).

*Class lives for depreciation*—20% reduction in lives (fiscal year 1973 estimate covers only the 20% reduction; no estimate made available on effect of dropping reserve ratio test and using 30th percentile for class lives).

*Employment of public assistance recipients under Work Incentive Program (WIN)* (fiscal year 1973 estimate).

*Political contributions* (fiscal year 1973 estimate). (Note—the check-off system is not here included: it is a tax expenditure in the sense that "votes" of taxpayer are relevant but no direct tax reduction is involved.)

*Existing items:*

*Child and dependent care:* The amount of the deduction was increased to \$4,800, the income limit increased to \$18,000–\$27,600, eligibility extended and household expenses added (fiscal year 1973 estimate).

*Exemption of interest on state and local debt:* The limitations on industrial development bonds were slightly relaxed.

The *quadruple asterisk* items involve:

*Existing items:*

*Standard Deduction in Excess of Minimum:* The low income allowance (minimum standard deduction) was increased to \$1,300, and this automatically reduces the standard deduction in excess of the minimum (fiscal year estimate). The estimate does not include this last change.



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

Mr. Benjamin Okner received his Ph. D. from the University of Michigan in 1965. He has been a staff economist for the Council of Economic Advisers and professor of economics at Ohio State University. He is now a member of the staff at Brookings Institution where he has been since 1968.

Mr. Okner and Mr. Pechman have a joint statement which, I understand. Mr. Okner will deliver in view of the fact that Mr. Pechman's voice is not what he would like it to be; but I understand he will respond to questions; is that correct?

Mr. PECHMAN. Yes, Mr. Chairman. I do want to say one thing before—

Chairman PROXMIRE. Before you say it, let me introduce you, too, so I can introduce both of you together.

Mr. Joseph Pechman is also at Brookings where he has been director of economic studies program since 1962. Mr. Pechman is the author of several books and numerous articles, reports and reviews, and is widely recognized as one of the great economists in our country. He is perhaps the outstanding economic expert in the Nation on our tax laws. He has appeared before this committee many times in the past.

It is a pleasure to welcome him back. Now go ahead.

**JOINT STATEMENT OF JOSEPH A. PECHMAN, DIRECTOR, ECONOMIC STUDIES PROGRAM, THE BROOKINGS INSTITUTION; AND BENJAMIN A. OKNER, ECONOMIST, THE BROOKINGS INSTITUTION**

Mr. PECHMAN. Thank you very much, Mr. Chairman. I would like to preface Mr. Okner's statement with just one remark about the basis on which the calculations he will report were made.

Mr. Okner and a number of people at Brookings have been developing what we call the "merge" file. This file merges the information gotten from tax returns and from census data for 30,000 families in the United States which constitute a representative sample of the United States.

The characteristic of this file is that it is now possible to make calculations of tax liabilities with great speed.

Chairman PROXMIRE. It is now possible because you now have computer assistance which you didn't have before; is that right?

Mr. PECHMAN. That is right. The information for these 30,000 families is on magnetic tape and it is now possible, with programing and a computer, to make calculations of tax liabilities under almost any system of taxation.

Since the sample is representative, when it is blown up to the universe it will give relatively accurate results. We have tested this many times and have found the results reliable. I think that it is a remarkable method of analysis. It is particularly useful in the kind of work the committee is doing.

One of the nice things about the file is that you can use the file to get an enormous number of breakdowns. You can obtain from the file, for example, distributions by income class, by family size, and by type of income and so on, breakdowns which up until now we have not been able to prepare by hand methods. I want to pay tribute to Ben Okner and his group for having developed this file.

Thank you very much.

Chairman PROXMIRE. Mr. Okner, go ahead.

Mr. OKNER. Thank you.

We are especially pleased, of course, to be testifying at this time.

Chairman PROXMIRE. May I just interrupt to say that your entire prepared statement will be printed in full in the record, including your very helpful tables that you have appended; and if you want to abbreviate your prepared statement we would appreciate it.

Mr. OKNER. Fine, I will do that, Mr. Chairman.

Let me go right into some of the major parts of our analysis. I think our major contribution to the committee's inquiry is to estimate the amount of what we call tax erosion in the aggregate and by individual income classes. I want to point out that the term "erosion," as we use it, is related to but is not exactly the same as tax expenditure as was used by Mr. Surrey, and as it is generally used by the Treasury Department.

By erosion we mean those features of the income tax law that are inconsistent with an economic definition of income or that are not necessary for effective income taxation.

The tax expenditure concept is really broader and more comprehensive than erosion because some expenditures—for example, those for medical expenses, or outlays for child care for families where there are working wives or both spouses working—generally are regarded by most people as appropriate deductions or provisions to have in an effective income tax.

I should also like to point out that there are many tax expenditures or features eroding the corporation income tax; those are not in our analysis, and what I will be talking about today deals only with the Federal individual income tax.

The norm that we use in our erosion calculations, as I say, is an economic concept of income. This is consumption plus tax payments, plus the net increase in the value of assets during the year.

We make a few modifications in this, primarily on practical, administrative grounds or because there are historical precedents that we don't feel are necessary to change or could be changed.

For example, we don't feel it is really practical to include capital gains in income until they are realized. We think that it is more appropriate to keep a separate gift and estate tax, and so we do not include gifts in our comprehensive income tax definition.

Similarly, we think that the separate corporation income tax is an appropriate device; therefore, we do not try to impute corporation income to individual stockholders. We tax only dividends and include those when they are distributed. Similarly, a very large item in our economy now that we do not include are the employer contributions to private health and pension plans because to do so would cause a major disruption in the whole pension system in the United States.

Those are the major modifications that we make in our economic definition of income.

We have a tax base which closely approximates our modified definition and it includes—and I won't go through the full list of items—realized capital gains or losses as well as gains that are transferred

by death or gift—instead of being completely able to escape taxation as under current law.

We do tax interest and State and local bonds; that is, we include these items in the income tax base.

We include net imputed rent on owner-occupied homes in taxable income and we also eliminate the deductions for mortgage interest and real estate taxes.

We eliminate most of the itemized deductions and the standard deduction but not the low-income allowance.

We eliminate the special exemptions that now exist for the aged and the blind, and the retirement income credit. And finally, we eliminate the rate advantages, although not the mechanics of income splitting for married couples.

If you take all those into consideration, plus a few others that are fully listed in the prepared statement, you get what we call comprehensive adjusted gross income. And if you look at actual income tax paid currently—I should mention by currently we are talking about 1972 since we have projected our figures so that they represent 1972 tax and income levels—to this expanded adjusted gross income figure, and examine effective tax rates by income class, you will find—and we show this in table 1 of the prepared statement—that tax rates now are really not terribly steep.

They rise from about 2 percent for families under \$3,000 up to a maximum of 32 percent for families with incomes of \$1 million or more; and it is interesting to note that not until you hit the \$100,000 income class do you find effective tax rates equal to 25 percent.

We find these to be relatively light tax burdens, and they certainly present a very different picture than you would get by looking at marginal tax schedules that go from 14 to 70 percent. In light of this, we think it is appropriate to ask two questions:

First, how much more money could be raised from the individual income tax if all the various eroding features of the tax law were eliminated; and second, if we were to adopt such a comprehensive tax base, how much could the present rates be reduced and still yield the same amount of revenue as we now get? It is to these questions that I now turn.

In 1972 under present law, total adjusted gross income will amount to about \$776 billion. If we adopted the comprehensive income definition that I outlined earlier, this would raise adjusted gross income to \$914 billion. That is an increase of \$138 billion or about 18 percent—those numbers are shown in our table 2 of the prepared statement.

This would increase taxable income by \$166 billion, which is more than the \$138 billion increase in adjusted gross income because elimination of exemptions and deductions increase taxable income but does not affect adjusted gross income. If we kept the 1972 tax rates and exemptions, the flat \$1,300 standard deduction, we would raise tax liabilities by \$77 billion; that is \$77 billion above the level that will be raised under current rates.

These are the result of a large number of very different provisions adding income to the tax base. But it is interesting that they are con-

centrated; that is, the increases in taxable income are concentrated at the low end of the income scale and the high end of the income scale.

At the low end of the income scale you find these large increases in taxable income resulting from the taxation of transfer payments. These are the social security, the public assistance, unemployment compensation and so forth.

At the high end of the income scale they are due almost entirely to the full taxation of capital gains income.

Now, this is not to say that we are about to impose very large, new taxes on low-income people by taxing transfer payments because, as you will see very shortly, what we do is modify the tax rates in such a way that low-income people would be relatively well off; that is, as compared to the current situation.

The point that I do want to make, however, is that this is income under a comprehensive economic definition of income; and if Congress feels that it should not be taxed because it is going to low-income people, and we would agree with that, the way to take account of such things is through increasing either the personal exemption or the low-income allowance which we would prefer as the more efficient way to do so.

We are not saying to go out and tax the poor and raise a lot of extra money; we are saying that transfer payments are income just as capital gains are income and just as tax-exempt interest on State and local bonds are income.

Let me, if I could, just step over to this chart in the prepared statement for a minute which indicates very graphically—I think I can still be heard—just what these various provisions mean at different income levels.<sup>1</sup>

What we show on this across the bottom is the amount of our expanded adjusted gross income. Because of the \$1,300 low-income allowance and the \$750 personal exemption in 1972, we start at \$2,000 of expanded adjusted gross income and this goes up to \$1 million on this particular chart.

The vertical axis shows the effective rates of tax; that is, tax divided by income.

Now, this very bottom line shows the actual effective rates that are now being paid and you can see they rise moderately at a progressive rate and reach a maximum of about 32 percent. I believe those numbers are shown in the table 1 that I referred to earlier.

The very top line shows the effective tax rates that would be paid under the comprehensive definition of income that I have outlined at 1972 tax rates which, of course, go from 14 to 70 percent.

You can see there is a very large difference between the actual and potential tax rates in the \$1 million and over class where effective rates if all income were taxed would go up to about 62 percent. What is the difference? Well, it is shown very graphically. The very large area that you see up here represents the effect of capital gains on lowering the effective tax rate at high income levels.

Income splitting—that is the rate advantages given to married couples which allow them, in effect, to be treated as if half the total in-

<sup>1</sup> See chart on p. 69.

come received by a husband and wife were received by each one—has a negligible effect down at the very bottom. As a matter of fact, in the lowest rate bracket it has absolutely no effect; it has a very small effect up at the very highest income brackets and it has its major effect in the so-called middle-income brackets, somewhere between \$20,000 and \$100,000—\$15,000, \$20,000 to \$100,000.

The tax-exempt and other preference income includes such things as interest on State and local bonds, interest on life insurance policies, which is now exempt from taxation, the effect of taxing the net imputed rent on owner-occupied homes and so forth.

This is shown in this area; and as Mr. Surrey pointed out, the effect of these increases as income rises, because we have rising marginal tax rates. Therefore, these special benefits become increasingly more important as your income rises.

And, finally, the transfer payments, as you can see, are concentrated down in this area and, of course, become negligible at high-income levels.

I think I have covered all of the areas on the chart except personal deductions. Those are deductions other than the ones we have eliminated and represent one of the major differences between the tax expenditure approach and the comprehensive approach that we have taken in the tax erosion paper since we have not eliminated all personal deductions.

We have eliminated, of course, the itemized deductions for mortgage interest and real estate taxes for homeowners. These are the homeowner preferences. Instead of completely eliminating the deductions for charitable contributions and for medical expenses, however, what we have done is place a floor on these. If the purpose of having these provisions, let us say charitable contributions, is to encourage charitable giving, which is what we find in the legislative history and justification for having such a provision, it makes absolutely no sense to give a deduction for the first dollar or \$2 or \$5 that people are going to give anyhow. Therefore, deductions for these very small amounts that amount to only 2 or 3 percent of your income, are considered as normal consumption items and not deductible, just as we do not allow deductions for food. It is a normal consumption item like the expenses for commuting to your job, or clothing to take a more apt example. We consider those to be perfectly normal consumption items and it is only the extraordinary contributions for which we allow deductions. Therefore, we have placed a 3-percent floor on charitable contributions.

The rationale for placing a floor under the medical expenses deduction, which is now provided, is similar. The rationale for this deduction is that very large, extraordinary medical expenses do in fact reduce the "ability to pay income tax." If someone gets hit with an astronomical bill as a result of a large auto accident or some disastrous disease, obviously, people would say such a family has a lower ability to pay than one that is healthy and well.

However, medical expenses equal to about 5 percent of your income are normal consumption; they include the occasional visit to the

doctor, the occasional cold, getting shots for a child, and so forth. There is no reason why such deductions or such expenses should be considered as reducing the family's ability to pay. And so we have placed higher floors on these deductions.

The current law, for example, has a 3-percent floor on medical expenses. This is considerably below the average 5 percent that is spent by most families for the medical expenses. Going back to the chart, this is what this large area up here represents. It is not a very large area but the topmost area includes the personal itemized deductions that we continue to allow under our modified income tax scheme.

Let me interrupt and ask if I have made this clear or if any of the committee members wish to ask questions?

Chairman PROXMIRE. Yes. I think you have as far as I am concerned.

Mr. OKNER. Fine.

Chairman PROXMIRE. This is the same chart as appears in your prepared statement?

Mr. OKNER. That is correct.

Well, getting back to the tax base and the taxes, we noted that keeping our present rates, which rise from 14 to 70 percent, and the comprehensive base would mean an increase in Federal income tax collections of some \$77 billion under our estimates. In table 2 we point out the revenue effect of each particular provision. For example, the total of taxing in full realized capital gains and the constructive realization of gains at gift or death amount to some \$14 billion dollars of that \$77 billion total.

Part of that increased revenue can be viewed as a reserve which could be used to lower income tax rates, and this is the part of the prepared statement in which we want to explore some of the ways in which taxes might be cut and the implications that each of these would have on the effective rates of tax that are paid by people at different income levels. To illustrate the range of possibilities we have chosen five different rate schedules, and these are shown in our table 4 in the prepared statement.

We show in the first column that under present law tax rates rise from 14 to 70 percent, as we know. We constructed five alternative tax schedules to be used with a comprehensive income tax base. The first one consists of simply cutting all tax rates by 43 percent across the board. This would produce a rate schedule that goes from 8 percent in the lowest bracket to 40 percent in the highest bracket.

I want to emphasize that each of these tax rate schedules will produce the same amount of revenue as will be collected in 1972 under the present 14 to 70 percent tax rate schedule and the present much smaller tax base.

The second schedule we have looked at is one that goes from 10 percent up to a maximum of 50 percent; the third, from 5 percent—we wanted to go down a little bit lower—up to 40 percent.

We included the fourth schedule because it is one that has been quite popular, at least among some writers in the literature who say that so little revenue is collected by all these high marginal rates anyhow, why don't you just have a comprehensive tax base and a flat

proportional tax schedule. In order to raise the same amount of revenue this would require a 16-percent marginal and average tax rate for all taxable income classes.

And you might note this schedule involves what does not look like a very large increase in the first two taxable income brackets but one that turns out to be very regressive and it provides a substantial cut in taxes at the very high income classes.

Our last and our preferred schedule is the one labeled No. 5. It is not directly comparable to the other schedules because we include a \$2,000 low-income allowance under this schedule. Instead of the \$1,300 low-income allowance that is in effect under present law, we raise it to \$2,000 and that, combined with \$750 exemptions, means that a family of four would not be subject to tax until their income reached \$5,000.

Rate schedule 5 starts at a marginal rate of 7 percent in the lowest tax bracket and rises to 44 percent in the highest tax bracket. It is our preferred schedule because it is the most progressive tax schedule that we have considered.

We show the effect of these rates and what they would produce in the last table of the prepared statement which shows by income class the effective tax rates under the comprehensive income tax base.

Let me just point out a few of the things that I have mentioned about the various schedules. Under the present rate schedule for the \$1 million and over group, the average effective tax rate is 32 percent. Under schedule 4, which I mentioned was a very regressive one—this was the straight 16 percent rate at all income levels—the effective rate is cut by more than half. It goes down to just under 15 percent.

Since the amount of income in each of these income classes is constant, these, in effect, reflect the changes in tax liability, or average tax liability. In other words, if you raised the same amount of revenue with that straight proportional 16 percent rate schedule, the average tax liability for those in \$1 million and over income class would be cut by more than half.

Under our schedule 5, as compared with the present law, which is shown in the very first column of table 5 in the prepared statement, the effective rates would drop substantially for the under \$3,000 class. It would be about the same \$3,000 to \$5000. In fact, just to summarize it, for all income levels below \$25,000 there would be substantial reductions in average tax liabilities and income tax liabilities would increase for those with incomes above \$25,000.

Of course, not everybody is going to be better off under a comprehensive base even under our schedule 5.

Let me summarize very quickly what is going to happen.

You are going to have a change in the liabilities of various groups in the economy. Tax burdens of homeowners would increase relative to those of renters because we would be taxing imputer rental income and eliminating homeowner's deductions. The tax burden for capital gains recipients would increase relative to the recipients of other property income. Married couples' tax liabilities would rise relative to those of single people, and people who now itemize would find

their tax liabilities would rise relative to those who now take a standard deduction.

We think these shifts in the distribution of tax burdens are desirable and would improve immeasurably the equity of the income tax. Of course, there are others who will have other views on this subject.

Let me just add one point in closing. We want to emphasize that our criticism of the present individual income tax should not be interpreted as a call for another tax to replace it or provide additional revenue whenever it is needed. Despite the enormous amount of erosion, the income tax is, on balance, progressive. The tax rates shown on the bottom line of the chart or in our table—the effective tax rates—do rise and the tax is, therefore, progressive. It is not as progressive as we would like it to be but it is, in fact, progressive.

There is no valid reason for turning to a mass consumption tax. As I am sure many of you know, there have been trial balloons floated, and we hear more and more about a retail sales tax or value-added tax.

At 1972 income levels, a rate increase of 1 percentage point across the board would increase the yield of the Federal individual tax by close to \$5 billion; that is just as it is, with all the eroding features and so forth and a similar increase would increase the yield from corporation income tax by almost \$1 billion. So you get close to \$6 billion of additional revenue by just a 1 percentage point increase in tax rates under the present laws.

If our revenues fall short of needed expenditures by \$10 or \$15 billion a year, which may not be a bad estimate, we can raise such revenues very easily simply by increasing current tax rates by 2 or 3 percentage points in both the individual and the corporation income tax.

Given this, we don't see any valid justification for introducing a mass consumption tax in lieu of additional reliance on the individual income taxes regardless of how imperfect we think they may be.

Thank you.

(The joint prepared statement of Mr. Pechman and Mr. Okner follows:)

JOINT PREPARED STATEMENT OF JOSEPH A. PECHMAN AND BENJAMIN A. OKNER<sup>1</sup>

#### WHY ARE INCOME TAX RATES SO HIGH?

We are pleased to have this opportunity to participate in the study of the Economics of Federal Subsidy Programs being conducted by the Joint Economic Committee. We are particularly pleased that the Committee is directing its attention to the subsidies on the tax side of the budget, as well as to those on the expenditure side. Tax expenditures are not only large—they account for about 25 percent of total budget outlays as conveniently measured—they are also very inequitably distributed, since the value of tax expenditures depends upon the tax rates at which they would otherwise be taxable, and these rates rise as income rises.

It is particularly appropriate that the Committee should be examining tax expenditures at this time, when federal revenues are clearly inadequate to pay for urgent public needs. Some public officials are already hinting that it may be

<sup>1</sup> This statement is a summary of the paper prepared for the Joint Economic Committee Compendium of Papers on the Economics of Federal subsidy programs, "Individual Income Tax Erosion by Income Classes." The views presented in this statement are those of the authors and not necessarily those of the officers, trustees, or other staff members of the Brookings Institution.



necessary to turn to another tax source—usually the value-added tax, the burden of which is similar to that of a general sales tax—to finance these needs. But it is unnecessary to go to this extreme. The Committee will find hidden among the tax expenditures a rich mine of revenue that could be used more effectively and more equitably for financing social programs than for subsidizing the particular groups that benefit from them.

Our contribution to the Committee's inquiry will be to estimate the amount of erosion of the federal individual income tax in the aggregate and by income classes, at projected 1972 income levels. The term "erosion" is related to, but is not the same as, the term "tax expenditure." By erosion, we mean the value of those features of the income tax law that are inconsistent with an economic definition of income or that are unnecessary for effective income taxation. The term tax expenditure is more comprehensive than the term erosion, because some tax expenditures—e.g., deductions for medical expenses and for outlays on child care by poor families with both spouses working—are regarded by most people as appropriate provisions in a personal income tax. Of course, there are also tax expenditures and erosion in the corporation income tax, but we confine ourselves to the individual income tax.

The erosion calculations are based on a new file of income data which was prepared at the Brookings Institution for estimating the distribution of federal, state, and local tax burdens by income classes. We call this file the "MERGE File" because it combines information on 30,000 families and single persons from the 1967 Survey of Economic Opportunity (SEO), conducted by the U.S. Census Bureau for the Office of Economic Opportunity, and from a sample of about 90,000 federal individual income tax returns filed for the year 1966. The File contains data for low-income SEO families who are not in the tax population, as well as the more complete—and more accurate—income tax information for higher income individuals. The basic economic unit in the MERGE File is the family or single unattached individual, and all of our analyses are presented in terms of families rather than tax returns.

Briefly, the process by which this remarkable file was developed consisted of estimating for each family unit in the SEO File the kind of tax return or returns (if any) that would have been filed by each family member. For those who were expected to be tax filers, the SEO unit was matched with a tax return selected from the Tax File, and the income data in the Tax File were substituted for the corresponding information in the SEO File. For those who were expected to be nonfilers, the only income information available was from the SEO record. As in the case of most field surveys, there was virtually no upper "tail" of the income distribution in the SEO File (i.e., incomes above \$30,000). At these levels, the Tax File was substituted in toto for the SEO File without going through the intermediate procedure of matching the two files. Finally, the income information in the MERGE File was corrected for nonreporting and underreporting, so that—with the appropriate weights applied to the sample units—the file accounts for the total income estimated to have been received in the United States in 1966.

The estimates for 1972 are based on projections of individual income sources from the 1966 levels.

#### RATIONALE OF THE EROSION CALCULATIONS

To determine the extent of erosion, we begin with a comprehensive definition of income which provides the "norm" against which the existing personal income tax can be assessed. We use a concept which corresponds as closely as possible to an economic concept of income, i.e., consumption plus tax payments plus (or minus) the net increase (or decrease) in the value of assets during the year. The modifications we make in this definition are dictated largely by practical administrative considerations or by historical precedents which need not (or could not) be broken for this purpose: first, capital gains would be included in income when realized or when transferred to others through gift or bequest; second, gifts and inheritances would be excluded from income; third, a separate corporation tax is retained, with dividends taxed in full at the personal level; and, fourth, employer contributions to private pension plans would not be considered current income to the employee. The first of these modifications is made because it is probably impractical to include capital gains in income until they

are realized or transferred. The second and third accept the present practice of separating estate and gift taxation and corporation income taxation from individual income taxation. The fourth is dictated by the fact that taxation of employer contributions to health and pension plans involved difficult practical problems that would require basic revisions in the nation's private pension structure.

A tax base which closely approximates this modified definition of economic income would involve the following revisions of the present federal individual income tax law: taxation as ordinary income of all realized capital gains and of gains transferred by gift or bequest; elimination of the tax exemption for interest from state and local government bonds; limitation of depletion allowances to cost depletion; taxation of interest on the current-year increment in the cash surrender value of life insurance policies; inclusion of net imputed rent in taxable income and elimination of the deductions for real property taxes and mortgage interest; taxation of transfer payments as ordinary income; elimination of most itemized deductions and of the standard deduction (but not the low-income allowance); elimination of the special exemptions for the aged and blind and the retirement income tax credit; and elimination of the dividend exclusion. In addition, we eliminate the rate advantage (but not the mechanics) of income splitting for married couples and the maximum tax on earned income.

When the federal tax actually paid is related to adjusted gross income corrected for the items just enumerated, we find that under the present law the tax liability is a relatively low percentage of income at all income levels. It rises from an effective rate of less than 2 percent of income below \$5,000 to 9 percent at \$10,000 and to a maximum of 32 percent at income levels of \$1 million and above (Table 1). Moreover, the average effective rate does not exceed 25 percent until income levels of \$100,000 and over. This is very different from the impression one gets from examining marginal rate schedules that rise from 14 to 70 percent.

In light of these relatively light tax burdens, it is appropriate to ask two questions: First, how much more money could be raised from the individual income tax if all the eroding features of the tax law were eliminated? Second, if the comprehensive tax base were adopted, how much could the rates be reduced and still yield the same revenue as the present income tax?

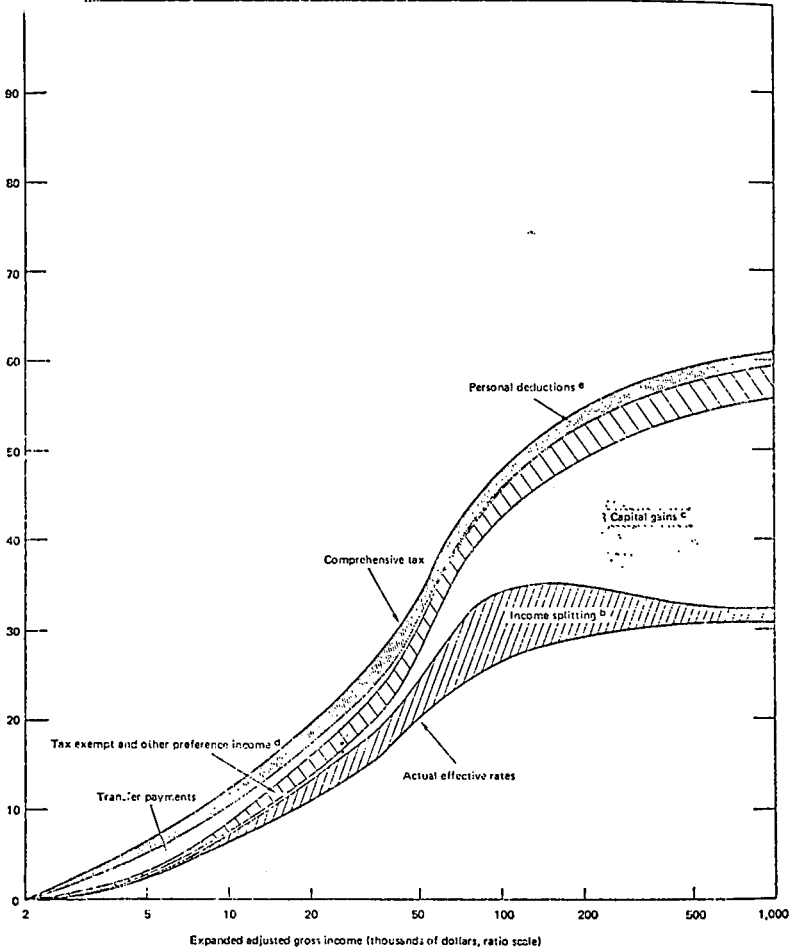
#### YIELD OF A COMPREHENSIVE INCOME TAX

We estimate that, in 1972, total adjusted gross income (AGI) of all family units in the United States will amount to \$776 billion under present law. Adoption of the comprehensive income tax would raise adjusted gross income to \$914 billion, an increase of \$138 billion or 18 percent. It would increase taxable income by \$166 billion and, at 1972 tax rates and exemptions and a flat \$1,300 standard deduction, would raise tax liabilities by \$77 billion (Table 2). About 10 percent of the tax increase would come from families with incomes under \$10,000, 43 percent from families with incomes between \$10,000 and \$25,000, and the remaining 47 percent from those with incomes of \$25,000 and over (Table 3). Although taxes would increase substantially at all income levels, the relative changes would be greatest for the very poor and the very rich. Largely due to the addition of transfer payments to the tax base, families with incomes under \$5,000 would find their tax liabilities increased threefold; and, as a result of the revised treatment of capital gains, families with incomes of \$100,000 and over would have tax increases of almost 100 percent.

The changes resulting from the adoption of the comprehensive income tax for families at different income levels can be seen at a glance in Figure 1. The top-most line on the chart indicates the effective tax rates that would be paid under the comprehensive tax; the lowest line indicates the rates now paid by those families. The intervening lines in the chart show the extent of erosion due to the major structural features enumerated above. The major conclusion one is forced to draw from this chart is that, while income tax erosion reduces taxes at all levels, the group benefitted most are those at the top of the income scale.

FIGURE 1. Influence of Various Provisions on Effective Rates of Federal Individual Income Tax, 1971 Act \*

Effective rates (percent)



\* Rates, exemptions, and other provisions of the Revenue Act of 1971 scheduled to apply to calendar year 1972 incomes.

b. Includes effect of removing maximum tax.

c. Includes effect of full taxation and constructive realization of capital gains.

d. Includes effect of taxing of interest on state-local bonds and life insurance policies; taxing net imputed rent (including effect of disallowing personal deductions for mortgage interest and state estate taxes); disallowing excess of percentage over cost or portion; disallowing excess of accelerated over straight-line depreciation; and removing unused exclusion.

e. Includes effect of removing additional exemptions for age and blindness, and dependent income credit.

#### ALTERNATIVE TAX RATE SCHEDULES

All or part of the increased revenue that would be collected under the comprehensive income tax can be viewed as a reserve to be used for general tax rate reductions. In this section, we explore ways in which taxes might be cut and the implications of each for effective rates of tax at various income levels and for the distribution of income after tax.

To illustrate the range of possibilities, we have calculated tax liabilities with five rate schedules that differ fairly substantially in their degree of progressivity (Table 4). However, each schedule will yield approximately the same amount of revenue that would be collected in 1972 under the Revenue Act of 1971.

1. The simplest way to cut taxes and still maintain the same yield as would be derived in 1972 is a straight 43 percent across-the-board cut in all marginal tax rates. This would lower the bottom bracket rate to 8 percent and would drop the top bracket rate to 40 percent. This is rate schedule 1 in Table 4.

2. In schedule 2, the marginal rates begin and end at higher levels than those in schedule 1—10 percent in the lowest bracket and 50 percent in the highest bracket—but the rates between \$6,000 and \$60,000 of taxable income are lower.

3. Schedule 3 greatly reduces the rate at the bottom and the top of the income scale, but imposes higher rates than schedule 1 for taxable incomes between \$2,000 and \$10,000 and than schedule 2 for taxable income between \$2,000 and \$14,000, along with equal or lower rates for taxable incomes of \$14,000 and over. The marginal rates in schedule 3 range from a minimum of 5 percent to a maximum of 40 percent, which involves a 64 percent cut in the lowest rate as well as a significant cut—48 percent—in the highest rate.

4. Schedule 4 applies a flat 16 percent rate on all taxable income.

5. The final schedule combines a top marginal rate of 44 percent with a generous low-income allowance of \$2,000. To keep within the revenues produced by the present-law income tax, the lowest bracket rate in schedule 5 begins at 7 percent.

In Table 5 we show the effective rates of tax under present law and under each of the alternative rate schedules. Schedule 4 is the least progressive of all the alternatives considered by a wide margin. On the average, the effective rates of tax would be substantially higher under this schedule than under present law for all income classes below \$25,000, while those at higher income levels would enjoy large tax savings. For example, under present law, the average tax paid by families with incomes of \$1 million and over is \$743,000; under schedule 4, the average for this income class falls to only \$345,000—an average tax reduction of more than 50 percent.

Schedule 5 is the most progressive and, we believe, most attractive of all the possibilities considered. (Under this schedule, all four-person families with incomes below \$5,000 would be exempt from tax.) Average tax payments would fall for families with incomes below \$25,000. Higher-income families would pay more taxes than they do now, but the increases are not excessive, in our judgment. Again looking at families with incomes of \$1 million and over, the average tax under schedule 5 rates is about \$938,000 as compared with \$743,000 under present law. This would represent a 26 percent increase in tax liability for the most affluent families in the nation.

Of course, the drastic reforms of the tax base, even when coupled with the tremendous rate reductions under schedule 5, will not reduce taxes for all families. In general, under the comprehensive income tax base and schedule 5, the tax burdens of homeowners would increase relative to those of renters; the burdens for capital gain recipients would increase relative to recipients of other income from property; married couples' burdens would rise relative to those of single persons; and the burdens of those who now itemize personal deductions would increase relative to those who use the standard deduction. We believe that such shifts in the distribution of tax burdens are desirable and would improve the equity of the income tax, but others will doubtless have other views.

In closing, we should like to add that our criticism of the present individual income tax should not be interpreted as a call for another tax to replace it or to provide additional revenue when and if it is needed. Table 1 reveals that, despite the enormous amount of erosion, the income tax is, on balance, progressive. We see no valid reason for turning to a mass consumption tax—whether it is a retail sales tax or a value-added tax—to raise more revenue. At 1972 income levels, a rate increase of 1 percentage point across the board would increase the yield of the federal individual income tax by about \$4.8 billion a year and the yield of the corporation income tax by about \$0.8 billion, or a total of about \$5.6

billion a year. After the recent tax-cutting spree—which most people seem to have enjoyed—revenues will fall short of urgently needed expenditures by perhaps \$10 or \$15 billion a year. Trial balloons have already been launched to see whether the public would accept a value-added tax to raise such revenues if they are earmarked for social programs. But such revenues can also be raised from the income taxes by raising the current rates by 2 or 3 percentage points. In our view, there is no valid justification for introducing a consumption tax in lieu of additional reliance on the income taxes, however imperfect they may be.

TABLE 1.—DISTRIBUTION OF EXPANDED ADJUSTED GROSS INCOME<sup>1</sup> AND FEDERAL INDIVIDUAL INCOME TAX BY INCOME CLASSES, 1972<sup>2</sup>

[Income classes in thousands; dollar amounts in millions]

Expanded AGI <sup>1</sup>	Expanded AGI amount	Federal individual income tax <sup>3</sup>	
		Amount	Percent of income
Under \$3.....	\$7,968	\$36	0.5
\$3 to \$5.....	27,610	475	1.7
\$5 to \$10.....	145,033	7,655	5.3
\$10 to \$15.....	216,483	18,843	8.7
\$15 to \$20.....	180,340	19,354	10.7
\$20 to \$25.....	109,886	13,301	12.1
\$25 to \$50.....	142,941	20,707	14.5
\$50 to \$100.....	41,178	9,672	23.5
\$100 to \$500.....	31,355	9,241	29.5
\$500 to \$1,000.....	4,360	1,324	30.4
\$1,000 and over.....	7,109	2,279	32.1
All incomes.....	914,262 <sup>†</sup>	102,888	11.3

<sup>1</sup> Expanded adjusted gross income is adjusted gross income as defined in the Internal Revenue Code modified to include the income items listed in the text.

<sup>2</sup> Based on projections of individual income sources from 1966 levels. Assumes personal income of \$925,000,000,000 in 1972.

<sup>3</sup> Revenue Act of 1971 applied to 1972 incomes.

Note: Details may not add to totals because of rounding.

TABLE 2.—COMPARISON BETWEEN AGI, TAXABLE INCOME, AND TAX LIABILITY UNDER PRESENT LAW AND UNDER A COMPREHENSIVE INCOME TAX, 1972 INCOME LEVELS

[Amounts in millions]

Item	AGI	Taxable income	Tax liability
Present law <sup>1</sup> .....	\$776,146	\$478,230	\$102,888
Elimination of rate advantages of income splitting <sup>2</sup> .....			21,565
Plus:			
1/2 realized capital gains.....	17,149	16,491	9,334
Constructive realization of gain on gifts and bequests.....	10,403	9,544	4,374
Tax-exempt State and local bond interest.....	1,916	1,892	1,193
Other preference income <sup>3</sup> .....	1,235	1,089	566
Dividend exclusion.....	2,200	1,924	673
Interest on life insurance policies.....	9,917	9,093	2,685
Homeowner's preferences <sup>4</sup> .....	15,545	28,700	9,642
Transfer payments.....	79,750	55,075	13,074
Personal exemptions and deductions.....		42,165	14,158
Equals: Comprehensive income tax.....	914,262	644,205	180,145

<sup>1</sup> Revenue Act of 1971 applied to 1972 incomes.

<sup>2</sup> Includes \$113,000,000 revenue effect of eliminating the 50 percent maximum tax on earned income.

<sup>3</sup> Excess of percentage over cost depletion and accelerated over straight-line depreciation.

<sup>4</sup> Includes effects of adding net imputed rent and disallowing itemized deductions for mortgage interest and real estate taxes.

Note: The increase in taxable income from "most" provisions is less than the change in AGI because some income goes to families who are not subject to tax.

TABLE 3.—COMPARISON BETWEEN TAX LIABILITIES UNDER PRESENT LAW AND UNDER A COMPREHENSIVE INCOME TAX, BY INCOME CLASSES, 1972 INCOME LEVELS

[Income classes in thousands; money amounts in millions]

Expanded AGI <sup>1</sup>	Tax liability		Increase in tax liabilities	Percentage distribution of tax increase	Percentage increase in tax liabilities
	Comprehensive tax	Present law <sup>2</sup>			
	(1)	(2)	(3)	(4)	(5)
Under \$3.....	\$128	\$36	\$92	0.1	255.6
\$3 to \$5.....	1,489	475	1,014	1.3	213.5
\$5 to \$10.....	14,238	7,655	6,583	8.5	86.0
\$10 to \$15.....	30,263	18,843	11,420	14.8	60.6
\$15 to \$20.....	31,737	19,354	12,383	16.0	64.0
\$20 to \$25.....	22,866	13,301	9,565	12.4	71.9
\$25 to \$50.....	38,099	20,707	17,392	22.5	84.0
\$50 to \$100.....	17,121	9,672	7,449	9.6	77.0
\$100 to \$500.....	17,076	9,241	7,835	10.1	84.8
\$500 to \$1,000.....	2,638	1,324	1,314	1.7	99.2
\$1,000 and over.....	4,489	2,279	2,210	2.9	97.0
All incomes.....	180,145	102,888	77,257	100.0	75.1

<sup>1</sup> Expanded adjusted gross income is adjusted gross income as defined in the Internal Revenue Code modified to include the income items listed in table 3.

<sup>2</sup> Revenue Act of 1971 applied to 1972 incomes.

Note: Details may not add to totals because of rounding. Col. (3): Col. (1) minus col. (2). Col. (5): Col. (3) divided by col. (2).

TABLE 4.—ALTERNATIVE MARGINAL TAX RATE SCHEDULES BY TAXABLE INCOME CLASS

[Income classes in thousands]

Taxable income	Present law <sup>1</sup>	Alternative tax schedules under comprehensive income tax				
		1	2	3	4	5
Under \$0.5.....	0.14	0.08	0.10	0.05	0.16	0.07
\$0.5 to \$1.0.....	.15	.09	.10	.07	.16	.08
\$1.0 to \$1.5.....	.16	.09	.11	.08	.16	.10
\$1.5 to \$2.0.....	.17	.10	.11	.10	.16	.11
\$2.0 to \$4.0.....	.19	.12	.12	.13	.16	.13
\$4.0 to \$6.0.....	.22	.12	.13	.15	.16	.14
\$6.0 to \$8.0.....	.25	.14	.13	.16	.16	.15
\$8.0 to \$10.0.....	.28	.16	.15	.17	.16	.16
\$10.0 to \$12.0.....	.32	.18	.16	.18	.16	.20
\$12.0 to \$14.0.....	.36	.20	.18	.19	.16	.22
\$14.0 to \$16.0.....	.39	.22	.20	.20	.16	.24
\$16.0 to \$18.0.....	.42	.24	.22	.21	.16	.26
\$18.0 to \$20.0.....	.45	.26	.22	.22	.16	.28
\$20.0 to \$22.0.....	.48	.27	.24	.23	.16	.29
\$22.0 to \$26.0.....	.50	.28	.25	.24	.16	.30
\$26.0 to \$32.0.....	.53	.30	.26	.25	.16	.32
\$32.0 to \$38.0.....	.55	.31	.28	.27	.16	.34
\$38.0 to \$44.0.....	.58	.33	.30	.29	.16	.35
\$44.0 to \$50.0.....	.60	.34	.32	.31	.16	.36
\$50.0 to \$60.0.....	.62	.35	.34	.33	.16	.37
\$60.0 to \$70.0.....	.64	.36	.36	.35	.16	.38
\$70.0 to \$80.0.....	.66	.37	.38	.37	.16	.40
\$80.0 to \$90.0.....	.68	.39	.40	.38	.16	.41
\$90.0 to \$100.0.....	.69	.39	.45	.39	.16	.42
\$100.0 and over.....	.70	.40	.50	.40	.16	.44

<sup>1</sup> Revenue Act of 1971 rate schedule for married couples filing separate returns.

Note: Rate schedules 1 to 4 are applied with a \$1,300 low-income allowance; rate schedule 5 assumes a \$2,000 low-income allowance.

TABLE 5.—EFFECTIVE TAX RATES UNDER THE COMPREHENSIVE INCOME TAX AND ALTERNATIVE RATE SCHEDULES, BY INCOME CLASSES, 1972 INCOME LEVELS

[Income classes in thousands]						
Expanded AGI <sup>1</sup> .....	Present law <sup>2</sup>	Schedule 1	Schedule 2	Schedule 3	Schedule 4	Schedule 5
Under \$3.....	0.5	0.9	1.1	0.6	1.8	0.4
\$3 to \$5.....	1.7	3.2	3.6	2.6	5.6	1.7
\$5 to \$10.....	5.3	5.8	6.2	5.9	8.7	5.0
\$10 to \$15.....	8.7	8.1	8.3	8.7	10.7	7.8
\$15 to \$20.....	10.7	10.1	9.9	10.6	11.8	9.9
\$20 to \$25.....	12.1	11.9	11.4	11.9	12.4	11.9
\$25 to \$50.....	14.5	15.1	14.1	14.3	13.1	15.6
\$50 to \$100.....	23.5	23.4	21.8	21.4	14.0	24.9
\$100 to \$500.....	29.5	30.8	33.7	29.8	14.3	33.8
\$500 to \$1,000.....	30.4	34.4	41.9	34.2	14.2	37.7
\$1,000 and over.....	32.1	36.0	44.7	36.0	14.6	40.0
All incomes.....	11.3	11.3	11.3	11.3	11.3	11.3
Measure of after-tax income inequality <sup>3</sup> .....	.3691	.3675	.3689	.3691	.3837	.3638

<sup>1</sup> Expanded AGI is adjusted gross income as defined in the Internal Revenue Code modified to include the income items listed in the text.

<sup>2</sup> Revenue Act of 1971 applied to 1972 incomes.

<sup>3</sup> This is the Gini coefficient of inequality which is a statistical measure of overall equality or inequality in the distribution of income. It may vary between 0 (indicating perfect equality) and 1 (indicating perfect inequality). A decrease in the value therefore signifies a more equal after-tax distribution of income and a more progressive tax structure.

Chairman PROXMIRE. Thank you, Mr. Okner.

Mr. Philip M. Stern is our next witness. He is an outstanding author on public policy issues. He was legislative assistant to Representative Henry Jackson and to Senator Paul Douglas, former chairman of this committee. His important book, "The Great Treasury Raid," is most interesting and I feel that he will be able to discuss subsidies with the committee from a somewhat different perspective than we get from economists.

Mr. Stern brings an ingredient which may get us action, where reason and logic failed to get us in the past; that is, a lively imagination and a knowledge of how to dramatize the tax inequities we should correct.

Mr. Stern.

#### STATEMENT OF PHILIP M. STERN, AUTHOR AND FORMER LEGISLATIVE ASSISTANT

Mr. STERN. Thank you, Mr. Chairman.

The object of my testimony is to try to do what Mr. Surrey mentioned in his very able testimony, which is to try to make the matter of tax expenditures understandable to the general public.

I would like to ask, if I may, that my full prepared statement be printed in the record, plus some charts that I have prepared and will show—

Chairman PROXMIRE. Yes; without objection, that will be done, the full prepared statement and the charts.

Mr. STERN. I think most Americans would probably be intensely surprised to find in their morning's newspaper an account such as the following:

WASHINGTON, D.C.—Congress today completed action on the final part of a revolutionary welfare program that reverses the usual pattern and gives huge welfare payments to the super rich but only pennies per week to the very poor.

Under the program, welfare payments averaging some \$720,000 a year will go to the Nation's wealthiest families—those with annual incomes of more than \$1 million.

For the poorest families—those earning \$3,000 a year or less—the welfare allowance will average \$16 a year, or roughly 30 cents a week.

The program, enacted by Congress in a series of laws over a period of years, has come to be called the rich welfare program after its principal sponsor, Senator Homer A. Rich, who, in a triumphant news conference told newsmen that the \$720,000 annual welfare allowance would give America's most affluent families "added weekly take-home pay of about \$14,000. Or, to put it another way," the Senator added, "it will provide these families about \$2,000 more spending money every day."

Total cost of the program—the most expensive welfare program ever voted—comes to \$77.3 billion a year.

Political observers have been surprised by the manner in which this huge sum has been allocated. Experts have calculated that only about \$92 million—about one-tenth of 1 percent of the total—will go to the 6 million poorest families in the country—the under \$3,000 income group.

By contrast, experts said, Congress has voted about 24 times that amount, more than \$2.2 billion, for families with incomes greater than \$1 million a year. Informed government sources said there are roughly 3,000 such families in the United States.

Moreover, Congress has allocated nearly 15 percent of the total, more than \$11 billion annually, in welfare payments to families with annual incomes of \$100,000 or more. Revelation of this fact brought angry protests from consumer groups here in Washington who pointed out that this \$11 billion outlay for the rich is five times the expenditures to provide food stamps for hungry poor families and 1,000 times the federal outlay for health programs for migrant farm workers.

Of greater consequence, political analysts here believe, is the potential discontent among the middle-classes, those in the \$10,000 to \$15,000 income group, for whom welfare payments under the Rich scheme will amount to \$650 a year, or about \$12.50 a week. While this is considerably more than the 30 cents a week allocated to the very poor, political pundits here feel that Congressmen who supported the Rich Plan might have trouble explaining to middle-class constituents why the very rich should receive welfare payments of \$60,000 per month, in contrast to the \$55 per month allocated to middle-income families.

Reporters asked Senator Rich whether the new plan would require wealthy families to work in order to receive their welfare payments, a usual requirement with most welfare programs. Senator Rich seemed puzzled by the question. "The rich? Work?" he said; "why, it hadn't occurred to me." Congressional experts advised newsmen that the program contains no work requirement.

The new program promises to be one of the most controversial acts ever passed by Congress. Countering the protests from the poor, glittering names from among the superrich have showered Congress with praise. "These generous welfare payments will at long last give the wealthy families of this country the incentives they need to invest in American enterprise," said one Pittsburgh heir to a large fortune, who delined to be identified by name. "The public will soon realize," he added, "that this is just what America has needed to bring jobs and prosperity for all."

This view was reinforced by a spokesman for the Yacht Builders Association of America, who predicted a great resurgence in the yacht industry. Christopher P. Wainwright III, President of Luxurama, builder of luxury resort homes in the Bahamas, was similarly ebullient about the future of his company.

Admittedly, the above news story sounds implausible, if not unbelievable. Yet that news story is essentially true. The facts and figures in it are real. Such a system is, in fact, part of the law of the land.

Only the law isn't called a welfare law. It goes by the name of "The Internal Revenue Code of 1954, as amended."



It is the basic income tax law of the United States.

Now, since a tax law takes money from people rather than gives it to them, what connection does the tax law have with the topsy-turvy welfare system in the news story?

The connection lies in the way Congress has played fast and loose with the 16th amendment to the Constitution, the one that authorized the original income tax. It empowered Congress to levy taxes on "incomes, from whatever source derived." But, over the years, as you know, Congress has put in this deduction or that exemption or exclusion or waiver or special rate. And every time it did that it excluded someone from paying what could and would have been collected if Congress had adhered to the 16th amendment.

To give a concrete example, Jean Paul Getty is one of the richest men in the world; he is said to be worth between \$1 billion and \$1.5 billion, and to have a daily income of \$300,000.

If Congress were to apply to Mr. Jean Paul Getty the standard of the 16th amendment, and were to tax his entire income, "from whatever source derived" at the current rates, Mr. Getty would, each April 15, write a check to the Internal Revenue Service for roughly \$70 million. But Jean Paul Getty is an oilman and, as is well known, oilmen enjoy a variety of special tax-escape routes. As a result, according to what President Kennedy told two U.S. Senators, Mr. Jean Paul Getty's tax, at least in the early 1960's, amounted to no more than a few thousand dollars. Annual tax saving to Mr. Getty—at current rates—\$70 million.

Compare the consequence of that \$70 million tax forgiveness that Congress bestowed on Mr. Getty with the effect if Congress had, instead, voted him a \$70 million welfare payment directly from the U.S. Treasury.

What is the difference between a tax forgiveness of \$70 million and a direct welfare payment out of the Treasury to Mr. Getty of \$70 million? I suggest there is no difference. In both cases Mr. Getty ends up \$70 million richer. In both cases the U.S. Treasury is \$70 million poorer. And in both cases the rest of the U.S. taxpayers have to pay \$70 million more to make up the difference.

The fact is, there really isn't any difference between a tax forgiveness and a welfare payment, so all those special exemptions and exclusions—for the lowly as well as for the mighty—amount to welfare payments.

Who are the fortunate citizens who get those welfare payments, and how much do they get in tax welfare payments each year?

Well, up until now, even the experts have, at best, been able to make only an educated guess. But now with the aid of computers, under the gifted guidance of Messrs. Pechman and Okner, making superhuman calculations based on actual tax return information, the secret is out.

The table that appears in detail in my prepared statement and that is summarized on chart I of my prepared statement, which shows who gets how much each year in annual welfare payments.

As you can see, if you are one of those lucky 3,000 families that makes over \$1 million a year, your annual welfare will be \$720,000 or, to put it in more conventional terms, your added weekly take-home comes to \$14,000 a week.

In the \$500,000 to \$1 million class, the yearly welfare payment is \$202,000.

Getting down into more normal ranges, at the \$25,000 to \$50,000 income level, the annual welfare is \$4,000; and the \$15,000 to \$20,000 range, it is \$1,200 or \$21 a week.

Now we come to where most of the taxpayers are, in the \$5,000 to \$10,000 range, where the need is greater. There, the welfare payment is \$340 a year, or \$7 a week.

And in the poorest range, for families with incomes under \$3,000, the annual welfare is \$16 or 30 cents per week.

Now, how is the \$77 billion of tax welfare distributed among various income groups? Is it distributed fairly? I think chart II of my prepared statement presents the matter graphically. In the under \$3,000 income category, there are 6 million families and, of the total \$77 billion, they get \$92 million or one-tenth of 1 percent of the total.

By contrast, in the over \$1 million income category, there are only 3,000 families; yet they get 24 times as much as these 6 million families in the under \$3,000 groups. In all, those 3,000 super-rich families receive tax "welfare" of over \$2.2 billion, the same amount that Congress has voted in total for payments for food stamps for hungry poor families in America.

Now, there are two particular tax preferences among the many that are listed in Mr. Okner's and Mr. Pechman's prepared statement that I would like to mention.

The first is income from tax-free bonds, bonds that are sold by States and municipalities, which is illustrated in chart III of my prepared statement.

Those clearly are owned only by financial institutions and by the very wealthy. For one thing, the poor don't have the spare cash to buy them. Even if they did, the low interest rates are not attractive; they are only appealing if you are in the top tax bracket.

Bear in mind that the income from these not only is tax-free it doesn't even have to be reported on tax returns. The chart shows that the tax "welfare" from tax-free bonds that goes to the over \$1 million group is \$36,000 a year. For the \$500,000 to \$1 million group, the annual tax "welfare" comes to \$19,000 a year. Even in the \$25,000 to \$50,000 group, not a bad income, annual "tax welfare" from this tax preference is only \$24; and in the \$10,000 to \$15,000 and the \$5,000 to \$10,000 you can see the annual "welfare" comes to just 80 cents per year, 10 cents per year, respectively.

I come, finally, to what I think is recognized at least by many as the tax preference that most flagrantly discriminates against the poor and in favor of the rich. I refer to the favored taxing of capital gains—the profits that are made from the sale of property, stocks and bonds, buildings, lands, real estate and the like.

The first point to be made about this is that only one taxpayer in twelve reports any capital gains. Eleven taxpayers out of twelve report none at all. This is a phenomenon of the rich and only of the rich. As you know, capital gains realized during lifetime are taxed at just one-half of the rate of earned income, and capital gains held until death are taxed at a zero rate.

Chart IV of my prepared statement shows the yearly welfare payments to families in various income groups from this one tax feature. In the over \$1 million group, \$641,000 a year counting both capital gains during lifetime and at death. In the \$500,000 to \$1 million group, annual "welfare" is \$165,000 a year, more than \$3,000 a week.

Now, let's get down to where most people are, in the \$20,000 to \$25,000 range, where the tax "welfare" comes to just \$120 a year. In the \$5,000 to \$10,000 range, it amounts to \$9 a year; and in the \$3,000 to \$5,000 income range, the yearly "welfare" from capital gains is only \$1.

One other point to be made about this is that the total welfare outlays, as a result of this one feature, come to nearly \$14 billion a year and I invite you to compare that with the \$220 million that the President has just impounded, presumably for fiscal reasons, for food stamp payments to hungry poor families. The total annual "welfare" to the rich from capital gains is 62 times that amount.

Just two other points that I want to make:

One is that if we went back to the 16th Amendment to the Constitution of the United States, which is a fairly revered document, and taxed income "from whatever source derived," it would be possible to reduce all tax rates by 43 percent and to have a tax rate schedule running from 8 to 40 percent rather than the present tax rate schedule of 14 to 70 percent. I am not necessarily advocating exactly that kind of schedule but I should think that a lowering of tax rates of that sort would be of immense interest to those who now bewail the high marginal rates that supposedly inhibit incentive, individual initiative, and the like.

The main point of my testimony is that it would be unthinkable for Congress to vote a welfare program of the sort that has been described in those charts, that would give welfare grants of \$14,000 a week to the Nation's wealthiest families versus 30 cents a week to the poorest. Yet Congress has done indirectly in the tax law what it would never dream of doing directly.

Why? In my view, it is in part perhaps because the field of taxation is complicated and the facts have not always been as clearly available as Mr. Pechman and Mr. Okner have made them. Perhaps some Congressmen have not been aware of precisely what they have been doing. But I think in large part it is because the general public has not understood what the tax laws have been doing to them, who gets what in the way of welfare payments, the equivalent of welfare payments under the tax law.

In my view, the public owes an enormous debt to the really gifted and brilliant analysis undertaken by Messrs. Pechman and Okner, and I think it should contribute considerably to public awareness of the real nature of the American income tax law and I hope that my testimony has contributed somewhat to that end, too.

Thank you.

(The prepared statement of Mr. Stern follows:)

PREPARED STATEMENT OF PHILIP M. STERN<sup>1</sup>

Most Americans would probably be intensely surprised to find, in their morning newspaper, an account such as the following:

"Washington, D.C. (AP-UPI).—Congress today completed action on the final part of a revolutionary welfare program that reverses the usual pattern and gives

<sup>1</sup> Author of "The Great Treasury Raid" (a best-selling 1964 book on tax loopholes) and of the forthcoming book, "The Rape of the Taxpayer"; also former legislative assistant to then-Congressman (now Senator) Henry M. Jackson of Washington and to Senator Paul H. Douglas of Illinois.

huge welfare payments to the super-rich but only pennies per week to the very poor.

"Under the program, welfare payments averaging some \$720,000 a year will go to the nation's wealthiest families (those with annual incomes of more than a million dollars).

"For the poorest families, those earning \$3,000 a year or less), the welfare allowance will average \$16 a year, or roughly 30 cents a week.

"The program—enacted by Congress in a series of laws over a period of years—has come to be called the Rich Welfare Program, after its principal sponsor, Senator Homer A. Rich who, in a triumphant news conference, told newsmen that the \$720,000 annual welfare allowances would give America's most affluent families "added weekly 'take-home pay' of about \$14,000. Or, to put it another way," the Senator added, "it will provide these families about \$2,000 more spending money every day."

"Total cost of the program—the most expensive welfare program ever voted—comes to \$77.3 billion a year.

"Political observers have been surprised by the manner in which this huge sum has been allocated. Experts have calculated that only about \$92 million—about one-tenth of one percent of the total—will go to the six million poorest families in the country (the under \$3,000 income group).

"By contrast, experts said, Congress has voted about twenty-four times that amount—more than \$2.2 billion—for families with incomes greater than one million dollars a year. (Informed government sources said there are roughly 3,000 such families in the United States.)

"Moreover, Congress has allocated nearly 15 percent of the total—more than \$11 billion annually—in welfare payments to families with annual incomes of \$100,000 or more. Revelation of this fact brought angry protests from consumer groups here in Washington, who pointed out that this \$11 billion outlay for the rich is four times the expenditures to provide food stamps for hungry poor families and one thousand times the Federal outlay for health programs for migrant farm workers.

"Of greater consequence, political analysts here believe, is the potential discontent among the middle-classes (those in the \$10,000–\$15,000 income group) for whom the welfare payments under the Rich scheme will amount to \$650 a year—or about \$12.50 a week. While this is considerably more than the 30 cents a week allocated to the very poor, political pundits here feel that Congressmen who supported the Rich Plan might have trouble explaining to middle-class constituents why the very-rich should receive welfare payments of \$60,000 per month, in contrast to the \$55 per month allocated to middle-income families.

"Reporters asked Senator Rich whether the new plan would require wealthy families to work in order to receive their welfare payments—a usual requirement with most welfare programs. Senator Rich seemed puzzled by the question. "The rich? Work? He said. "Why, it hadn't occurred to me." Congressional experts advised newsmen that the program contains no work requirement.

"The new program promises to be one of the most controversial acts ever passed by Congress. Countering the protests from the poor, glittering names from among the super-rich have showered Congress with praise. 'These generous welfare payments will at long last give the wealthy families of this country the incentives they need to invest in American enterprise,' said one Pittsburgh heir to a large fortune, who declined to be identified by name. 'The public will soon realize,' he added, 'that this is just what America has needed to bring jobs and prosperity for all.'

"This view was reinforced by a spokesman for the Yacht Builders Association of America, who predicted a great resurgence in the yacht industry. Christopher P. Wainwright III, president of Luxurama, builder of luxury resort homes in the Bahamas, was similarly ebullient about the future of his company."

Admittedly, the above "news story" sounds implausible, if not unbelievable. Yet that news story is essentially true. The facts and figures in it are real. Such a system is, in fact, part of the law of the land.

Only the law isn't called a welfare law. It goes by the name of "The Internal Revenue Code of 1954, as amended."

It is the basic income tax law of the United States.

## WHY TAX PREFERENCES ARE EQUIVALENT TO "TAX WELFARE PAYMENTS"

Since a tax law takes money *from* people, rather than paying money to them, what connection does the tax law have with the topsy-turvy welfare system in the "news story"?

The connection lies in the way Congress has played fast and loose with the Sixteenth Amendment to the Constitution—the one that authorized the income tax in the first place.

That amendment empowered Congress to levy taxes on "incomes, *from whatever source derived.*" (Emphasis added.) But, over the years Congress has chosen to depart from that standard and to put into the law a special exception for this kind of income or a special deduction for that kind, or an exclusion or a waiver or an exemption or a special low rate or some other kind of escape hatch. And every time it did that it excused someone from paying what could and would have been collected if Congress had stuck to the Sixteenth Amendment and taxed "incomes, from whatever source derived."

To give a concrete example, Jean Paul Getty is one of the richest men in the world; he is said to be worth between a billion and a billion and a half dollars, and to have a *daily* income of \$300,000.<sup>2</sup>

If Congress were to apply to Mr. Jean Paul Getty the standard of the Sixteenth Amendment, and were to tax his entire "income, from whatever source derived" at the current tax rates, Mr. Getty would, each April 15, write a check to the Internal Revenue Service for roughly \$70 million. But Jean Paul Getty is an oil man; and, as is well known, oil men enjoy a variety of special tax escape routes. As a result, according to what President Kennedy told two United States Senators, Mr. Jean Paul Getty's tax, at least in the early sixties, amounted to no more than a few thousand dollars. Annual tax saving to Mr. Getty (at current rates): \$70 million.

Now, compare the consequences of that \$70 million "tax forgiveness" that Congress bestowed on Mr. Getty with the effect if Congress had, instead, voted him \$70 million welfare payment directly from the U.S. Treasury.

## CONSEQUENCES OF A \$70 MILLION DIRECT WELFARE PAYMENT TO MR. GETTY

1. Mr. Getty is \$70 million richer.
2. The U.S. Treasury is \$70 million poorer.
3. The rest of the U.S. taxpayers have to pay \$70 million more taxes to make up the difference.

## CONSEQUENCES OF A \$70 MILLION TAX FORGIVENESS TO MR. GETTY

1. Mr. Getty is \$70 million richer.<sup>3</sup>
2. The U.S. Treasury is \$70 million poorer.<sup>4</sup>
3. The rest of the U.S. taxpayers have to pay \$70 million more taxes to make up the difference.

The fact is, there is no real difference, and so all the special gimmicks and escape hatches that Congress has been writing into the tax laws over the years—for the lowly as well as for the mighty—amount to welfare payments for the lucky recipients of the tax favors.

## WHO GETS "TAX WELFARE PAYMENTS"

Who are these fortunate citizens? How much do they get in "tax welfare payments"?

Well, up until now, even the experts have, at best, been able to make only an educated guess; but now, with the aid of computers (at the Brookings Institution, under the expert guidance of Joseph Pechman and Benjamin Okner<sup>5</sup>) making super-human calculations based on *actual* tax-return information, the secret is out. The following shows who will get how much "tax welfare payments" in 1972 as a result of that largest of all welfare bills, the Internal Revenue

<sup>2</sup> Esquire, Oct. 1969, p. 146.

<sup>3</sup> Than if he had paid the full tax called for under the 16th Amendment.

<sup>4</sup> Than it would have been had Mr. Getty paid the full tax.

<sup>5</sup> All the figures in this testimony are based on their paper, "Individual Income Tax Erosion, by Income Classes," submitted to the Joint Economic Committee hearings on Federal subsidy programs, January 14, 1972.

Act of 1954, under the tax rates voted by Congress in 1971, applied to estimated 1972 incomes:

If you make—	Your average yearly family income is—	Your average yearly tax welfare payment will be—	Your average increase in weekly "take-home pay" will be—
Over \$1,000,000.....	\$2,316,872	\$720,448	\$13,854.78
\$500,000 to \$1,000,000.....	673,040	202,752	3,899.07
\$100,000 to \$500,000.....	165,992	41,480	787.21
\$50,000 to \$100,000.....	65,885	11,911	229.07
\$25,000 to \$50,000.....	32,028	3,897	74.94
\$20,000 to \$25,000.....	22,181	1,931	37.13
\$15,000 to \$20,000.....	17,198	1,181	20.79
\$10,000 to \$15,000.....	12,346	651	12.52
\$5,000 to \$10,000.....	7,481	340	6.54
\$3,000 to \$5,000.....	4,017	148	2.85
Under \$3,000.....	1,345	16	.31

One can get an idea of the fairness with which the "tax welfare payments" are distributed from these statistics:

This income group	Has this many families	Gets this amount of "tax welfare payments"
Under \$3,000.....	6,000,000	\$92,000,000
Over \$1,000,000.....	3,000	\$2,200,000,000
	Comprises this percent of the population	Gets this percent of "tax welfare payments"
Under \$10,000.....	45.7	10.0
Under \$15,000.....	70.6	24.7
Over \$100,000.....	0.3	114.7

<sup>1</sup> The 14.7 percent that goes to families with incomes over \$100,000 amounts to \$11,400,000,000 per year.

#### TAX "WELFARE" PAYMENTS FROM THE FAVORED TAXATION OF "CAPITAL GAINS"

Without question, the tax preference that brings about the most unequal tax "welfare" allowances, as between the rich and the poor, is the preferential tax treatment accorded so-called "capital gains"—the profits made on the sale of "capital assets" (stocks and bonds, buildings, factories, machines, land, etc.) that a person has owned for more than six months.

There are two aspects to the favorable taxation of capital gains. The first is that the profits on capital assets that a person sells during his lifetime are taxed at no more than *half* the rate that would ordinarily apply to such income.<sup>6</sup> On the first \$50,000 of a person's capital gains, the maximum tax is just 25 percent—markedly lower than the 70 percent top rate applicable to earned income.

But on capital assets that are held until death, the capital gains tax is not 35 percent or 25 percent. It is zero. No one—neither the original owner of the assets nor his heirs—*ever* pays a tax on the rise in value that took place prior to his death. An estimated \$10.4 billion passes tax-free in that manner every year.

According to the figures produced by Messrs. Pechman and Okner of the Brookings Institution, the preferential tax treatment of "capital gains" represents tax "welfare" allowances totalling nearly \$14 billion per year. (That is nearly six times the Federal outlay for environmental protection.)

Who gets these enormous "welfare" payments?

One starts from the fact that only one taxpayer in twelve has *any* capital gains. Eleven out of twelve have none.

<sup>6</sup> Actually, the law permits half of a person's capital gains to be ignored totally in figuring up his taxable income (which helps rich people a great deal, because it reduces hugely the amount of otherwise-taxable income for which they have to find special deductions or "tax shelters").

The clinching statistics come from the Brookings study by Messrs. Pechman and Okner that show that the annual tax "welfare" from the favorable treatment of "capital gains" (both during life and at death) is as follows:

<i>If you make—</i>	<i>Your yearly tax "welfare" from tax-free bonds is—</i>
Over \$1,000,000.....	\$640,667
\$500,000 to \$1,000,000.....	165,000
\$100 to 500,000.....	22,630
\$50 to 100,000.....	3,795
\$25 to 50,000.....	534
\$20 to 25,000.....	120
\$15 to 20,000.....	55
\$10 to 15,000.....	24
\$5 to 10,000.....	9
\$3 to 5,000.....	1
Under \$3,000.....	

#### TAX "WELFARE" FROM INCOME ON TAX-FREE STATE AND LOCAL BONDS

Another tax preference that provides generous tax "welfare" for the very wealthy, but none whatever for the vast majority of Americans is the tax-free status of income from state and local bonds, which are overwhelmingly in the hands of financial institutions and wealthy individuals. Most Americans own no such bonds; for one thing, they don't have spare cash to invest in such bonds; and even if they did, the comparatively low interest rate these bonds carry (because of their tax-free nature) makes them unattractive investments except for those in high tax brackets.

The Brookings analysis shows the per family tax "welfare" flowing from tax-free bonds as follows:

<i>If you make—</i>	<i>Your yearly "welfare" from from capital gains will be—</i>
Over \$1,000,000.....	\$36,333
\$500,000 to \$1,000,000.....	19,167
\$100 to 500,000.....	3,630
\$50 to 100,000.....	205
\$25 to 50,000.....	24
\$20 to 25,000.....	4
\$15 to 20,000.....	1
\$10 to 15,000.....	1
\$5 to 10,000.....	
\$3 to 5,000.....	
Under \$3,000.....	

#### TAX PREFERENCES LISTED IN THE BROOKINGS STUDY

The two preferences just cited—capital gains and tax-free bond interest—account for about \$15 billion of the \$77.3 billion<sup>7</sup> of tax "welfare" expenditures listed in the Brookings study.

#### IF ALL TAX "WELFARE" WERE ELIMINATED, TAX RATES COULD BE CUT 43 PERCENT

One important fact is that all tax rates could be reduced by about 43 percent (without any loss of Federal revenue) if Congress were to eliminate the entire \$77.3 billion of tax preference listed in the Brookings paper, and enact a "no-preference" law that adhered to the 16th Amendment.<sup>8</sup>

An across the board 43 percent tax-rate cut would leave us with tax rates ranging from 8 to 40 percent (instead of the present rates of 14 to 70 percent. In theory at least, such a rate schedule should be intensely appealing to those who now bewail the high rates supposedly applicable to the wealthy as inhibitors of individual initiative and enterprise.

<sup>7</sup> For a list of tax preferences making up this \$77.3 billion, see Appendix I.

<sup>8</sup> The 43 percent rate reduction calculated by the Brookings economists assumes that a "comprehensive" tax law would still contain a \$750 personal exemption and the present \$1,300 low-income allowance, and would permit deductions for medical expenses in excess of 5 percent of gross income, for charitable deductions in excess of 3 percent of income, for state and local income taxes, and for interest expenses up to the amount of "property income" reported on the individual's tax return.

CONCLUSION: CONGRESS HAS DONE INDIRECTLY WHAT IT WOULD NEVER DREAM  
OF DOING DIRECTLY

The main point of this testimony is that it would be unthinkable for Congress to even consider a proposal to vote annual welfare grants of \$14,000 a week for the wealthiest versus 30 cents a week for the nation's poorest families. Yet Congress has done indirectly—in the tax laws—what it would never dream of doing directly.

Why?

In part, perhaps, because the field of taxation is so very complicated that many members of Congress may not have been aware of the precise consequences of the various preferences they have been voting, over the years.

But in large part it is, I believe, because the public itself has not fully understood what Congress has done in the tax laws. In my opinion, the brilliant analysis undertaken by Messrs. Pechman and Okner should contribute greatly to public awareness of the real nature of the American income tax law, and I hope this testimony has contributed to that same end.

APPENDIX I.—TAX PREFERENCES LISTED IN THE BROOKINGS STUDY

<i>Tax preference</i>	<i>Yearly tax "welfare" (billions of dollars)</i>
Tax preferences for the aged and blind-----	2.9
Personal deductions (most itemized deductions plus standard deduction above \$1,300 per taxpayer)-----	11.3
Tax-free government payments to individuals (Social Security, Railroad Retirement, Veterans benefits, etc.)-----	13.1
Tax preferences to home owners-----	9.6
Certain deductions for mineral depletion, for fast depreciation and tax-free dividend income-----	1.3
Tax-free interest on life insurance savings-----	2.7
Joint-return filing and other rate reductions accorded "heads of households" and others-----	21.6
Capital gains-----	13.7
Tax-free bond interest-----	1.2

CHART I

1972 TAX "WELFARE" PROGRAM

IF YOU MAKE:	YOUR YEARLY TAX "WELFARE" WILL BE	YOU'LL GET ADDED WEEKLY "TAKE-HOME" OF
OVER \$1 MILLION	\$720,000	\$14,000
\$500,000 TO \$1 MILLION	\$202,000	\$3,900
\$25 - 50,000	\$4,000	\$75
\$15 - 20,000	\$1,200	\$21
\$5 - 10,000	\$340	\$7
UNDER 3,000	\$16	30 CENTS



## CHART II

## WHO GETS TAX "WELFARE" ?

<u>INCOME GROUP</u>	<u>NUMBER OF FAMILIES</u>	<u>TOTAL YEARLY TAX "WELFARE"</u>
UNDER \$3,000	6,000,000	\$92 MILLION █
OVER \$1 MILLION	3,000	\$2.2 <u>BILLION</u> ████████████████████

## CHART III

## INCOME FROM TAX-FREE BONDS

IF YOU MAKE:	YOUR <u>YEARLY</u> TAX "WELFARE" FROM TAX-FREE BONDS WILL BE:
OVER \$1 MILLION	\$36,000
\$500,000 TO \$1 MILLION	\$19,000
\$25-50,000	\$24
\$10-15,000	80 CENTS
\$5-10,000	10 CENTS

## FAVORED TAXING OF "CAPITAL GAINS"

IF YOU MAKE:	YOUR YEARLY TAX "WELFARE" FROM "CAPITAL GAINS" WILL BE:
OVER \$1 MILLION	\$641,000
\$500,000 TO \$1 MILLION	\$165,000
\$20 - 25,000	\$120
\$5 - 10,000	\$8
\$3 - 5,000	\$1

Chairman PROXMIRE. I am sure it has and I want to thank all of you gentlemen for what I think is a most dramatic, expert, competent presentation on what is really at the heart of the problem.

Mr. STERN, very appropriately, I think, you put the distribution of tax subsidies and special benefits in the context of the family.

Let's look at that:

The poverty-line family with annual earnings of less than \$3,000 receives \$16 a year, or roughly 30 cents a week.

The average family with \$10,000 to \$15,000 in annual earnings receives \$650 a year, or \$12.50 a week.

The superwealthy families with incomes over \$1 million a year receive \$750,000 a year, or \$14,000 a week.

I am amazed at the unequal distribution of these benefits. I knew they were great but I am astounded, frankly, at the dramatic discrepancies, and the results are more upsetting if you look at these distribution effects in relation to the percentage of the populace affected at each end.

In your prepared statement you show that about half of the population, the 50 percent of all citizens with an annual income less than \$10,000, gets only 10 percent of the special benefits in the tax law. The top 3 percent of the population, those with annual incomes over \$100,000, however, get 15 percent of the special benefits in the tax law.

Mr. STERN. I think that is the top three-tenths of 1 percent.

Chairman PROXMIRE. I beg your pardon.

Mr. STERN. It is even more egregious.

Chairman PROXMIRE. One-third of 1 percent—

Mr. STERN. That's right.

Chairman PROXMIRE. They get 15 percent of the special benefits from the tax law.

My question is, how is it that the average citizen puts up with such an unfair system?

Mr. STERN. Well, as I say, I think that one of the difficulties has been that this field has been represented as being so complex that the average person feels he need not even try to understand it because it is all written in the most opaque and obscure language in the tax laws. It is very complicated and I think this may be one of the first times that there have been solid figures that would show an average family just what he is and isn't getting in the way of tax preferences.

I think one of the troubles is that the figures that you have seen here today are the result of tax laws passed piecemeal over the years. Each time it has gotten a little bit worse, as Mr. Surrey has said, and the public has been nibbled away at. Each time it was a little bit more difficult to point to the effect per income group of each individual tax law provision. It is when you take them all together, as Messrs. Pechman and Okner have done, that it becomes dramatic and I hope as a result of this people will wake up.

Chairman PROXMIRE. Well, how about the argument that in many cases there are substantial services, in effect, performed or at least results achieved by having this kind of incentive?

For example, the oil depletion allowance, and I have been one of those who has been critical of it and fought hard to reduce it, nevertheless does provide some incentive for exploration and for increasing our resources of oil. The provision in the tax law that most of the witnesses have referred to respecting low-income housing does provide some encouragement for putting more resources into an area where we all recognize we need them. Most of them have some kind of logical, reasonable justification.

Do you think that the people in the general public have the feeling that they are getting a fair bargain or some bargain at least with this kind of privilege?

Mr. STERN. If they do, I think they don't understand just what benefits the public is and isn't getting from these various preferences.

If we were to apply any sort of hardheaded business standard to the kind of outlays that Congress has been permitting under the tax program, most of them would never get in.

For example, a study by the Treasury a couple of years ago showed that in exchange for a \$1.5 billion of tax outlays for oil depletion allowance we were stimulating about \$150 million of new oil findings. That is a 10-to-1 expenditure in relation to the return.

Chairman PROXMIRE. So that to the extent this is a justification, one of the first steps would be to do as Mr. Surrey and others have recommended, if we do have this made visible, that we do require annual analysis of the effectiveness of this expenditure so that we are in a position to ask questions about it: Is it working? Are we getting a fair return? What are the costs? What are the benefits? What is the relationship between the two? Should it be modified? Change it? Should we make it an explicit expenditure, et cetera?

If we do that, aren't we in position to get on top of this?

Mr. STERN. I would say that that is a first step but only a first step and that, as Mr. Surrey has suggested, the real way to get control of this is to get control of it and appropriate whatever subsidies you want. For example, the oil depletion allowance is supposedly an incentive or a reward for risktaking. But a landowner who doesn't lay out a penny for drilling a well on his land and therefore takes no risk

gets just as much depletion allowance, gets just as much reward, gets just as much of the taxpayers' money in the depletion allowance as does the man who takes the risk in drilling the well.

Chairman PROXMIRE. I think there is a lot to that.

We had testimony the other day by Mr. Gonzalez of the American Petroleum Institute who, I thought, did make a reasonable and effective appeal. I didn't agree with him but I thought he made a very strong pitch: We had not really thought through our alternative. For the oil depletion allowance I proposed an alternative, an explicit subsidy for exploration, but he pointed out if you do that you are in an uncharted area. How do you determine, how do you really make this payment? Do you make it on the basis of success or exploration? If you make it on exploration you are obviously going to have people out there drilling nothing just to get the subsidy. If you make it on the success, this is extraordinarily difficult and we haven't had any experience with it; so I do think there are benefits here that we haven't completely thought through and I think we would be in a stronger position if we consider what the alternatives are, that these things do in most cases achieve some public end, although I would agree with you that we need a whale of a lot more information before we can know whether we should go ahead or not.

Mr. STERN. Most of them are very poorly targeted. Mr. Surrey was talking about the subsidy for low-income housing. That goes primarily to the builder, not those in need of housing. And, getting back to the oil example, I am always intrigued by the free enterprisers who come in and say, "It's not enough for us to get a full tax deduction in case we drill a well and lose. We need something more than that."

No business is risk-free and usually when a businessman takes a risk and loses, he gets a tax deduction. Why isn't that good enough for the oil industry? If it isn't, let's appropriate a subsidy targeted to the real risktakers.

As you know, the large oil companies spread their risks so greatly among huge numbers of wells that for them there is little or unknown risk factors. They know pretty well what their overall returns are going to be and yet they get the lion's share of the \$1.6 billion, in revenue loss that the taxpayers suffer.

Chairman PROXMIRE. Mr. Pechman, you wanted to comment?

Mr. PECHMAN. I agree with everything that Phil Stern said, but I don't want to minimize the problem of educating the public on this.

Even showing the figures as dramatically as Phil Stern has done may not be good enough. There are enormous tax advantages to large groups in our population, middle-income classes, low-income classes as well as high-income classes. Try to eliminate, for example, the deduction for interest or for property taxes on owned homes. These deductions should clearly be eliminated because homeowners received a double benefit; they are not taxed on the value of the services provided by the home and they also get the deductions for interest and property taxes. I think you might have a revolution on your hands if you tried to eliminate these deductions.

The problem is that, as you pointed out, practically all of these tax subsidies or tax expenditures do some good for the people that get them and sometimes even from the national standpoint as well.

Unless Congress decides it wants to tax all income from whatever source derived, without any preferences, I am very, very pessimistic about getting tax reform.

The problem in the past has been that the Treasury has trooped up to the Ways and Means Committee and Finance Committee with a smorgasbord of tax reforms which added up to \$2 or \$3 billion and the committees take a little bit of the smorgasbord and then believe their job is done. A year later they add to the tax preferences.

So I don't want to minimize the problem of education. If you want really to reform the tax system, it is not enough to say that you have got to clip the wealthy or the middle classes. You have to say, "We are going to tax all income, and we are going to eliminate unnecessary deductions. If we are going to provide subsidies, we will do it by way of direct expenditures."

Unless you resolve to do that, I am very pessimistic about the chances of tax reform.

Chairman PROXMIRE. Let me follow up on that.

I believe you and Mr. Okner deserve a whale of a lot of praise on the breakthrough you have made in determining who gets the benefits from the tax subsidies and other special benefits in the tax system. But I am puzzled why we have not had these data much sooner. Can't the Treasury make these same calculations? They are the agency responsible for collecting taxes. Why hasn't the Treasury done this? This isn't a partisan criticism; this is something that would apply to the Johnson and the Kennedy administrations as well as the Nixon and Eisenhower administrations.

Mr. PECHMAN. Well, at least in partial defense of the Treasury, we have not been able to do this until now. These techniques have been developed only recently. They are able to do much of what we have done.

Chairman PROXMIRE. They certainly have more money than you did.

Mr. PECHMAN. They sure do.

Chairman PROXMIRE. Even than Brookings has.

Mr. PECHMAN. They sure do, and we would be delighted to work with the Treasury and congressional committees to refine the figures, if necessary.

Chairman PROXMIRE. Why isn't this information made public so that the average citizen can know who carries the tax burden?

Mr. PECHMAN. I think it should be made public.

Chairman PROXMIRE. Mr. Surrey, do you have a comment?

Mr. SURREY. Yes, because in many respects the gentlemen of the Congress control these matters. In defense of the former Treasury, the Johnson Treasury for the first time in a report in 1968 published the tax expenditure budget. It had never been published before, because these are evolving concepts and evolving ways of looking at the problem.

Chairman PROXMIRE. You are not saying the Congress is keeping the Treasury from releasing information, are you?

Mr. SURREY. Well, to some extent I am. I will finish and I will point that out.

Chairman PROXMIRE. All right.

Mr. SURREY. Second, the Treasury in 1968 did indicate the data that were then available, of the kind that Mr. Pechman is now pro-

viding. Mr. Pechman, as he indicated, has gone further and properly so.

In this 1971 Revenue Act, the question arose as to publishing this tax expenditure material in the Budget of the United States. A version to this effect was passed by the Senate but not adopted in the final bill. The Senate said: "This material on tax expenditures should be made available along with each budget, but that was not adopted by the Congress." So what I am indicating is that on some of this—

Chairman PROXMIRE. I think the Javits amendment was adopted in the closing days of the session this year.

Mr. SURREY. No.

Chairman PROXMIRE. Then it was rejected in conference.

Mr. SURREY. Yes.

Chairman PROXMIRE. And then it was agreed to by the Treasury they would make this available not only to the tax committees but to the Joint Economic Committee also.

Mr. SURREY. But not as part of the budget.

Chairman PROXMIRE. Not as part of the budget?

Mr. SURREY. Where it belongs.

Mr. PECHMAN. There is one difference between the tax expenditure table and our calculations. We also distribute it by income classes and I hope that the congressional committees involved will insist that the Treasury Department distribute its estimates by income classes, because I think that is the way to bring the important point home to the public.

Mr. SURREY. I agree with that.

Chairman PROXMIRE. Let me just say that I don't think there is anything in the world to prevent the Budget Director from putting this in the budget. Congress was requiring them to do it whether they like it or not and that failed but the Budget Director can still put tax expenditures right directly in the budget if he wants to.

Mr. SURREY. He certainly can.

Chairman PROXMIRE. My time is up.

Mr. Blackburn.

Representative BLACKBURN. Thank you, Mr. Chairman. I have mixed emotions about the testimony.

First of all, I am grateful for the work that the gentlemen before us have done in researching and developing techniques for bringing data before us; but the net effect of the testimony has been either a strong argument against the progressive income tax or against financial success and I have not figured out which one is the real thrust of your position here.

Mr. STERN, I notice you criticized very strongly the small percentage of taxpayers who take advantage of capital gains treatment. I understand you are an author.

Mr. STERN. Yes, sir.

Representative BLACKBURN. Aren't authors allowed some special treatment for income from a writing that has taken several years to prepare?

Mr. STERN. They may be allowed to average, but one of the ways in which authors are discriminated against is that income from the fruit of the mind of an inventor gets capital gains treatment but income from the fruit of the mind of an author is denied that.

Representative BLACKBURN. But you are allowed to average the income over a period of years?

Mr. STERN. Everybody is.

Representative BLACKBURN. Well, do you average your income from your publications over the time that it takes you to prepare them?

Mr. STERN. If I ever have the good fortune to have uneven income and a big spurt of income, I surely will.

Representative BLACKBURN. Don't you think we should eliminate that treatment for authors because there are just very few of us who are authors in the country? If that kind of logic applies to people getting capital gains treatment, I think the same logic should apply to all.

Mr. STERN. My point was not that the favorable treatment of capital gains should be eliminated because it applies to only a few people. I think it—excuse me.

Representative BLACKBURN. I think what you favor—

Mr. STERN. My argument is that a dollar that comes in in capital gains is just as effective for buying food or shoes or a yacht or paying taxes as a dollar of ordinary income and I don't see why either should be taxed more favorably than the other. In fact, I think that to give a preference to unearned income over income earned by the sweat of one's brow or one's personal ingenuity and endeavor goes against all the precepts of American ideals in Poor Richard's Almanac and the rest.

Representative BLACKBURN. I disagree with you on that 100 percent. In fact, we had three noted economists before us yesterday and all of them agreed that there are economic justifications for the capital gains treatment. One of the reasons for capital gains treatment is the fact that in many instances capital gains represent increases due to inflation over which the individual had no control and had no desire to see it come about and when some individual finds himself having to sell a home that he has invested in over a period of years he may well find that due to the effects of inflation and the tax liability on the sale that he can't go out and buy another home of equal quality.

Mr. STERN. Well, I have not seen any credit for inflation given, for example, to wage earners who have cost-of-living escalation increases in their wage contracts. Nobody else gets credit for inflation.

Representative BLACKBURN. I will agree with you there. I think the tax structure should be revised because to the extent that Government creates inflation, and Government is the primary cause of inflation, it is effectively levying increased taxes on the same wage earner because, as our dollars go up, our real income may not go up commensurately and yet the tax rate applies to the higher number of dollars we are making, so I think there is a good justification for arguing that the Congress—and, as I say, I am not opposed to these hearings; I think we are doing a public service by bringing these things out in the open; but there is, to just assume that everything that Congress has done in the past is based on pure idiocy is not a valid assumption, in my opinion, and when we look at capital gains treatment and say, well, it is just evil per se, what we are failing to take into account is the fact that there is a basis for this, an economic basis. There may be a social incentive as well because we are encouraging people to invest money with the idea that perhaps they will create new jobs and new

products for American consumers; so I just protest the underlying thesis that seems to be coming through from most of the testimony today, that, first of all, economic success is evil. I don't think it is evil.

Well, if economic success is not evil, then why shouldn't a man who is enjoying it enjoy the fruits of it? Well, if we are to say he is to enjoy the fruits of it, how do we then justify the progressive income tax? So I think there are some fundamental questions being very blithely ignored.

Mr. PECHMAN. I want to contribute one point to this discussion.

We are not trying to say that Congress consists of a bunch of idiots. What we are trying to say is that Congress has created a tax system with tax rates that go from 14 to 70 percent, but that nobody pays those rates on their entire income. All we are asking you to do is to take a look at that tax structure and ask yourselves whether you prefer to have 14 percent to 70 percent rates with the present kind of eroded tax base, or a tax base which goes from 8 percent to 40 percent with a comprehensive tax base?

Nobody is suggesting that capital gains be taxed at 70 percent. What we are interested in doing is to lower the rates on all taxpayers and, I submit, that there is a real economic question—which is not an idiotic question—whether it would be preferable to tax differing types of incomes at huge differential rates ranging from zero to 70 percent or to tax all income at the same rates. I don't think Congress has asked itself this question and I hope it will.

Representative BLACKBURN. Certainly that is one of the purposes of these hearings, to begin asking ourselves these questions, but I don't want us to begin with an assumption that everything that has been done in the past is either evilly motivated or the act of pure idiocy on the part of this Congress or any previous Congresses.

Now there have been reasons and there have been arguments presented to the various congressional committees to justify these special treatments. I will grant you that some of them may have been far more persuasive than they should have been but I know there is a great deal of publicity about the number of families who pay no income tax on large incomes. Well, Congress is the one that has created these special treatments.

I certainly don't see why we should criticize a person for taking advantage of the very things that Congress has created to give that person incentives to take advantage of special tax treatments. It is up to the Congress to look into the laws and decide whether they need changing.

Mr. SURREY.

Mr. SURREY. I think that is getting closer to the heart of the problem. There are justifications for a lot of these provisions. As you indicated, they are generally an incentive to do this or an incentive to do that. Congress says, "We want to spend public money for this goal because we believe it is a desirable public goal."

Now I think there are two problems when you get to that point: One is in many cases since these have been imbedded in the tax laws for a considerable period of time nobody has really raised the question: Are we still interested in this goal any longer? The provision is there and it tends not to get examined. That is one point.



Second, I think a lot of Congressmen and people in the Treasury, and, people generally, don't appreciate the consequences of encouraging things through the tax laws because they fail to recognize the upside down character of the tax expenditure system. When you assist somebody by throwing a deduction into the tax system, inevitably because it is a progressive system, you are assisting the person at the top more than you are assisting the person at the bottom, and you are not assisting people who are not within the tax system. So that if, as I earlier indicated, if you were to say, for example, "Yes, we do want to help this activity, we do want to encourage this program, we do want to help these people," and if you also said, "But you are not allowed to open the tax code for that purpose," my guess is that nearly every one of these expenditures would look differently in those areas where you would still agree you wanted to help programs or people.

The money would be distributed in quite a different way.

Representative BLACKBURN. I want to make this observation before my time expires: You say public money should go for a certain purpose, and you assume that all income is public money, but I think you start from an invalid premise because to the extent we allow a person to retain his income, you are saying we allow him to retain public moneys.

If you take the opposite approach and say that whatever the person owns is his money, and therefore we should allow him to use his money except to the extent that Government requires funds from him, then you give the whole argument a different complexion. I don't assume that because we allow a person to retain part of his earnings through either special tax treatments or whatever, that those are public moneys; and if we adopt the approach that Mr. Pechman has mentioned and, in fact, I believe Mr. Stern made the same approach, that we should appropriate funds for each one of the desirable purposes, then we end up with a further creation of governmental apparatus with further political influences which you are all deploring here today. I have seen few instances where Government is able to do things better than private enterprise.

I hope, Mr. Chairman, we will have some witnesses who will testify on the other side of these issues as to what will be the effect on the capital market for investment purposes. It may be a very simple matter to increase the gross revenues to the Treasury by \$70 billion, but what is it going to do to the \$70 billion that would otherwise be out in the market for buying consumer goods or going into capital plant and investment and this sort of thing. So I do hope, Mr. Chairman, we will have witnesses prepared to give both sides of this picture.

Thank you again, gentlemen, for your testimony.

Mr. OKNER. I wonder if I could just make one comment with regard to capital gains raised by Congressman Blackburn?

Under the current law at 70 percent tax rate, capital gains go in at 50 percent and are therefore effectively taxed at 35 percent. In addition, they may be subject to an additional 10 percent minimum tax under the provisions of the 1969 reform act, so that right now, today, for the very wealthiest people capital gains are taxed at 45 percent.

In our preferred rate schedule the highest marginal tax rate is 44

percent, so we actually want to cut the tax on capital gains, not increase it. And we certainly are not against personal success.

Chairman PROXMIRE. Mr. Stern.

Mr. STERN. Just in the interest of full disclosure, Congressman, I ought to mention that in addition to being an author, I am blessed with very considerable means and I am one of the great beneficiaries of the preferential treatment of capital gains. But as I testified before the Senate Finance Committee, I think among the people who are most discriminated against and most unfairly discriminated against in that regard are you gentlemen in the Congress. You work very hard—I know, having worked up here on the Hill—for your \$42,500 a year. If I take some of my money and invest it, let's say in Xerox and don't lift a finger thereafter and the people at Xerox do all the work and I get a huge gain, I might pay a lower marginal rate than you would on your earned income and I think that is an outrage. I don't see why you put up with it. [Laughter.]

Representative REUSS. Mr. Stern, you may have done more for tax reform with that last observation that we have been able to do in many years.

I think it is a most lively panel, Mr. Chairman. I came here because I read about it in the Washington Post this morning, which referred to the panel as "public wits." They have lived up to their billing.

Chairman PROXMIRE. I don't want to say they were half right. [Laughter.]

Representative REUSS. I have several questions.

My first one goes to the general question how did we get into this outrageous situation where our tax system, instead of representing a rational method of keeping the public treasury in funds, looks more like a Swiss cheese? I don't think it is useful to argue whether it is due to pure idiocy or impure idiocy, or whatever it might be due to.

I would like to list several things which occur to me as possible contributors to the evil, and then ask you gentlemen whether you agree and whether you would add any other factors.

First of all, the gentleman at the head of this country, the President, at least the last two, Mr. Johnson and Mr. Nixon, have been obviously highly uninterested in plugging these tax loopholes. President Johnson wouldn't even respond to a law of Congress which asked him to forward over his name a tax reform program.

The present President has not only further riddled the tax system with loopholes, but now that it is increasingly inequitable, wants to repair some of the damage he has done by putting on a national sales tax.

The present Secretary of the Treasury, Mr. Connally, is Mr. Loophole. When he appeared before the Joint Economic Committee last year, I had written him a month before saying, "I am going to ask you about the 10 or 12 leading loopholes in the tax system." They are those mentioned today and others. He was in favor of every one of them, didn't want to change any one of them.

I could name the press which, while it prints these stories that we release from time to time of the 112 over-\$200,000 income taxpayers in 1970 who didn't pay any income tax at all, really hasn't been very good on its function of education. For instance, on this Connally testimony last February, instead of reacting with outrage that the Secretary of the Treasury, who was supposed to protect the revenues, was in favor

of giving them away, about all the press wrote, as I recall, was "wasn't it a wonderful thing that the Secretary of the Treasury knew so much about the tax laws."

Well, that isn't being very energetic.

The Congress, the tax-writing committee, as is well known, are heavily peopled with worthy gentlemen who believe in these loopholes, and aren't about to do anything about them. In sending bills to the floor, at least in the House, the bills are traditionally accompanied by a closed rule, which forbids amendments.

And, finally, the Congress, the Senate and House itself, and here I criticize myself as much as anybody else, tends to follow its tax-writing committees like a troop of lemmings, with the result that we have the tax system we have.

Would any of you gentlemen care to either delineate other factors which have produced this sorry spectacle, or to differ with me if you think I have put anybody on the list who does not deserve it?

Mr. Stern.

Mr. STERN. I think there is one factor that hasn't been mentioned and that is the connection between economic power and political power that is represented by the system we now have of financing political campaigns.

Representative REUSS. Well, I did mention that. The roster of Johnson contributions and Nixon contributions looks very much like a roster of those who benefit by those loopholes. That was the state of affairs which was sought to be remedied in the last Congress, but under threat of veto was not.

Mr. STERN. I think what these charts reflect is that almost the ultimate in the denial of one man, one vote, when six million families get one-tenth of 1 percent of the total benefit, 3,000 families get 24 times that amount. That couldn't happen under a genuine one man, one vote system.

So one has to ask why is it that the 3,000 families have such an enormously disproportionate apparent influence on the law-making process?

Representative REUSS. Mr. Pechman.

Mr. PECHMAN. Well, I don't want to make any insidious remarks about anybody in our political system; everybody has what he regards as good justifications for his loopholes. But the thing that I have observed over the years is that Congress is very sensitive to the fact that many of these eroding features which we have put on the table seem to be very popular with large groups of people. They are not necessarily a majority, but when you put them together—those who benefits from personal deductions, exclusions and so on—you will be pitted against large masses of voters. It is a problem of education which Congress has not participated in, I must say, except for this committee, which is one of the few exceptions.

If the voters were to be informed about the problem; namely, that the majority is not really getting its share—it is being distributed very unequally—perhaps we could get to first base. But every time that Stanley Surrey went up to the Congress with a menu of tax reform the Congress cut him down. They cut him down not because they were sinister people but because they were worried about the reaction to the reforms in their districts.

And so I repeat the point that Mr. Stern has made: I think this is a matter of public education primarily, as well as perhaps correcting some features of our political system.

Representative REUSS. Mr. Surrey.

Mr. SURREY. I think it is a little hard. [Laughter.]

I come back in part to what Congressman Blackburn was saying and part of what you are saying, Mr. Pechman, some of these provisions do reflect national priorities.

Take tax exempt bonds. We do want to assist State and local governments; there is no question about that. What has held us up is that we have not been able to find a program of assistance to State and local governments in the financing of capital items that is as meaningful to them as tax exemption.

I don't think there is anybody who defends the commission paid, through tax exemption, to wealthy people in the United States as a method of assisting State and local governments. There is nobody in Congress that defends that. There is no wealthy person that really defends that. The defenders of that commission have been Governors and mayors, because it is important to them. Consequently the task is to find the right expenditure program to substitute for the tax exemption.

Now I think we are nearly on the verge of doing it. I think the State and local governments are willing to say that if the Congress enacts an elective subsidy on State and local taxable bonds, an interest subsidy of around 50 percent, that subsidy program will eliminate in the future new issues of tax exempt bonds, because they will choose to issue taxable bonds. The interest subsidy will give the State and local governments the assistance they need, and it will still be their choice. It will eliminate Mr. Stern's welfare payment to the wealthy because we would have found a substitute direct system.

As to the deduction of home mortgage interest, and property taxes, Congress does believe in assisting homeownership in the United States. You are never going to get rid of those deductions until HUD comes up with some alternative system that is fairer and more effective.

Take low-income housing. The tax assistance to investors in low-income housing is necessary today to pay the developer a profit for his work. It is the only mechanism we have so far devised. It is a stupid mechanism and a silly mechanism and a wasteful mechanism and an unfair mechanism, but until HUD focuses on the problem and says, "Here is a program that will directly assist the developer," you are not going to eliminate this provision because it does serve some purpose. If the expenditure committees of Congress were to say to the executive departments and the Budget Bureau: "You go through this tax expenditure budget and you tell us where you can justify these present programs, and where you do want the money, you give us an alternative program." If the Ways and Means Committee were also to say that, then I think you would start making progress in that area.

Representative REUSS. If I could comment on Mr. Surrey's point: While it is true that many of the loopholes we are talking about do have some ostensibly worthy point—they help State and local governments, help homeownership, and so on—there are a great many other loopholes which don't have a single thing to be said for them, like, for

instance, capital gains. Can any one of you four gentlemen give the slightest justification of a tax system which says that where an owner of Xerox stock, which he bought at \$10 and which is currently selling at \$100, gives the stock to his son, the son properly takes it at a basis of \$10, so that if the son sells it at \$100 he pays a tax on the gain of \$90; whereas if donor passes it to the same son, not inter vivos but by will, the son does not take that substituted basis, and thus pays no tax on the gain which he sells at \$100—is anybody going to defend that, or say there is the slightest social purpose in that?

Mr. SURREY. No.

Representative REUSS. Our so-called tax system is full of those things; and while I commend the chairman for focusing these hearings on the question of subsidies and whether they are justified or not, we must not lose sight of the fact that many of these giveaways are not subsidies at all for any useful purpose, but simply the act of a fiscal highwayman who takes from the general public to give to certain favored few who do nothing for society. Any objection to that?

Mr. SURREY. No; and in my prepared statement I said I think there are a number of these which if one sat back and said, "Do national priorities require financial assistance to these groups?" The answer would be clearly "no" and they would be dropped. In those areas the problem is simply counting votes in the Congress of the United States. Are there the votes or are there not the votes for those programs?

My guess is the next time around if there were proper Treasury leadership the master of escape from capital gains tax at death you mentioned would disappear from our taxes.

Mr. STERN. May I add a point to what Congressman Reuss has said?

Representative REUSS. My time is up; if the chairman and Congressman Blackburn will permit.

Mr. STERN. Concerning the list of factors contributing to the present state of affairs I would like to reemphasize what Mr. Pechman said a few moments ago about the need or desirability of wiping the slate clean so that nobody gets any preference because, it seems to me, that one of the great factors is that the tax equity, as it is now conceived, is being taxed as little as the next guy who in one way or another is comparably situated. That is a very difficult argument to counter.

If the people who have iron ore royalties get capital gains and the people with coal royalties don't, the people with coal royalties have a mighty good argument; so one leads to the next; one preference leads to the next.

Mr. OKNER. I would just like to add one thing which may have been missed. It is not original but really it is in the nature of a summary of many of the other comments.

I think one of the factors you could add to the list is the fact that the Congress is organized in such a way that appropriations and expenditures are handled by one set of people and taxes and tax expenditures are handled by a different set of people. Aside from their passing in the hall there seems to be little overall consideration of the budget.

As Mr. Surrey, for example, pointed out; you can't go in and wipe out the tax exemption on State and local bonds without simultaneously guaranteeing to the 80,000 governmental units in the United

States that there will be a substitute form of subsidy on their interest obligations.

Chairman Mills cannot guarantee that. The Appropriations Committee is the one which is in charge of that and you can't—

Representative REUSS. You don't know Chairman Mills.  
[Laughter.]

Mr. OKNER. Maybe Chairman Mills could; I won't argue that. But the point is that—and again as Phil Stern has pointed out—the equity of treating man A and man B always comes into consideration. You do have to wipe the slate clean and, really, if you are going to take a given item that has a congressional mandate for proper priority and so forth and take away a tax expenditure for that, you have to simultaneously put in an explicit expenditure for it. I would not urge you very strongly not to take piece A, piece B, piece J, out of any one of, say this list of things, and say: "We will do that," and not do the rest. The whole thing ought to be done as a package and with, in effect, a slate-wiping.

We have seen in recent history what disaster can occur from a smorgasbord approach. Our neighbor Canada had an excellent Royal Commission with some of the finest tax recommendations that I have seen in a long time. However, when the Parliament got finished picking and choosing from among them, I don't know exactly what the final result is but I gather there have been few, if any, improvements.

Representative BLACKBURN. Mr. Chairman, I understand we can submit written questions.

Chairman PROXMIRE. Yes, indeed.

(The following information was subsequently supplied for the record:)

RESPONSE OF JOSEPH A. PECHMAN AND BENJAMIN A. OKNER TO ADDITIONAL  
WRITTEN QUESTIONS POSED BY REPRESENTATIVE BLACKBURN

*Question 1.* In the statement which you submitted to the Committee you estimated that "Adoption of the comprehensive income tax would raise adjusted gross income to \$914 billion, an increase of \$138 billion, or 18 percent. It would increase taxable income by \$166 billion and, at 1972 tax rates and exemptions and a flat \$1,300 standard deduction, would raise tax liabilities by \$77 billion." How much of the additional 77 billion dollars in tax liabilities would be attributable to "Imputed Rent"? Would the addition of this "imputed rent" concept to our tax laws result in many home owners being inclined to leave their homes in disrepair so as to reduce their tax liabilities?

*Answer.* We have not calculated the separate revenue effects of taxing net imputed rent and eliminating the itemized deductions for real estate taxes and mortgage interest. However, on the basis of the figures show in Table 2, page 14, of the statement, we estimate that the revenue effect of taxing imputed rent would be about \$5.2 billion while eliminating the related itemized deductions would yield about \$4.4 billion.

It seems extremely unlikely that taxing imputed rent would induce homeowners to lower their expenditures on maintenance and repairs in order to reduce their tax liabilities. Since the *net* increase in tax liabilities for the average homeowner would be small relative to the value of his home, it would not be to his advantage to let his house deteriorate in the interest of reducing his tax.

*Question 2.* Who would calculate these "imputed rents"? Wouldn't a government agency which had the power to establish "imputed rents" have an overwhelming impact on real estate values, seriously restricting the free market forces which have traditionally interacted to set the value of real estate?

*Answer.* The amount of net imputed rent can be calculated either as a given percentage return on net equity in the house (that is, market value less debt) or by subtracting all costs of homeownership from the *gross* rental value. Since

the return on net equity approach is simpler to administer, this is probably the method that would be used in taxing net imputed rent. Since every homeowner knows, or can easily determine, the amount of his mortgage, there should be no problem in determining the amount of debt on any given property. The determination of the market value of a given property is more difficult, but it should be possible to base the estimates on property tax assessments. These estimates, of course, would be subject to the usual audit procedures and standards of the Internal Revenue Service and could be challenged by them. (To avoid wholesale understatement of value by homeowners, some economists have suggested that the statute might provide that the government have the automatic privilege of purchasing any piece of property for 150 or 200 percent of the value as stated by the taxpayer. However, we do not believe that such an extreme policy would be necessary.) Thus, there is no need to establish any new government agency to administer this tax provision.

*Question 3.* What hardships might the establishment of this system of "imputed rents" work on elderly couples who would be compelled to pay taxes on "imputed rent"?

*Answer.* We see no particular hardships on elderly couples from taxing imputed rent in the manner described; in fact, we do not see hardships for low-income families of any age. The increase in the low-income allowance to \$2,000 we have suggested, along with the large reduction in marginal tax rates for all taxpayers would serve to eliminate or reduce taxes dramatically for a majority of the taxpayers—especially so for those at the low end of the income scale. If there are any hardships in the form of increased tax payments from taxing net imputed rent, they would be felt by high income individuals who own three or four different dwellings—a beach house in Florida, a hunting lodge in Vermont, the hideaway at the shore, etc.—rather than the average American family.

Chairman PROXMIRE. Gentlemen, first I want to say there should be no argument that this panel constitutes a prejudice against success. I have been trying to just estimate the incomes of you gentlemen and without seeing your income tax returns, I am sure you are all in the top 10 percent. You are not unsuccessful in any sense; you are enormously successful. We wouldn't have asked you here as expert witnesses if you were not outstanding in your area and in your field; and I think that probably most, probably all of you—I don't ask you to tell me whether this is true—fall in the one out of 12 taxpayers who benefit from the capital gains tax. I want to—I know Phil Stern does in a very big way—come to that now. I want to ask all of you gentlemen, since your work does show that the major tax provision redistributing income to the rich is the capital gains provision, since it shows that people with \$20,000 to \$25,000 income receive only \$100 benefits from this while those with \$1 million in income get \$640,000 a year, I would like to ask you the significance of this:

First, as I understand it, you are only talking about realized capital gains and not accrued gains in each case; is that correct?

Mr. OKNER. Yes.

Chairman PROXMIRE. All right. Second, Mr. Pechman, would you explain briefly for the subcommittee how capital gains work and the justification for it. What good are capital gains?

Mr. PECHMAN. Well, the capital gains preferential treatment consists of eliminating from the tax base, for most taxpayers, half of long-term capital gains.

Chairman PROXMIRE. Half of their income so if they make a profit of \$500,000 they only are taxed on \$250,000; is that right?

Mr. PECHMAN. For that particular type of capital gain, that's right. Only \$250,000 are included in income. But there is an additional minimum tax added which can be as much as 10 percent of the capital gain less the current tax paid on that gain.

But you are quite right that half is excluded from income.

The justification for this treatment has been that, in our type of capitalistic society, it would be disaster to include capital gains in taxable income in full at the very high marginal tax rates that had been in effect in the last three or four decades. My own view is that it would be unwise if Congress were to include capital gains in taxable income in full with a 70 percent top bracket rate.

If you did include capital gains in taxable income in full, you could lower the rates very, very substantially and, I think, our capitalistic system would do very much better under the rate structure we have suggested.

Chairman PROXMIRE. Of course, I am a little bit either skeptical or just don't understand some of the statistics I have gotten here. You tell me under your scheme capital gains would be taxed less than they are now?

Mr. PECHMAN. For some people.

Chairman PROXMIRE. Now they are 45 percent. I understand you to say they would be 40 percent in what you would propose.

How could this be if this is the big loophole and where is the money coming from?

Mr. PECHMAN. I think Mr. Okner's example might have been misinterpreted. What he is saying is that, for some people who are now subject to the very top rate applicable to capital gains, that is those people who have very large capital gains and are subject to the minimum tax, they may be subject to marginal rates in excess of 35 percent.

On the other hand, most capital gains are subject to a maximum tax rate of 35 percent.

Chairman PROXMIRE. I see.

Mr. PECHMAN. And therefore we would increase the tax on those gains moderately.

Chairman PROXMIRE. The staff tax study estimated capital gains at \$7 billion on the basis of some rather old Treasury data. The Pechman-Okner findings are that the cost of the capital gains subsidy or special benefit is \$14 billion, twice the earlier estimate.

What do you attribute this enormous increase to?

Mr. PECHMAN. Partly to passage of time. The estimates that the staff included in its tax expenditure table, I think, are 4 years old. The Treasury has not—

Chairman PROXMIRE. How many years old?

Mr. PECHMAN. At least 4 years old.

Chairman PROXMIRE. Four years wouldn't explain that kind of an increase, would it?

Mr. PECHMAN. Well, as I recall it, from 1966 to 1969 the amount of capital gains reported on tax returns increased from \$20 billion to \$30 billion.

I think that, if the Treasury looked at it again, it would find that, at current levels of the stock market, and at the increased amount of capital gains that are likely to be reported, their estimates are very, very low indeed.

Chairman PROXMIRE. How reliable are your estimates?

Mr. PECHMAN. My guess is that our estimates of the tax implications of constructive realization at gift or death are low. I think that



the estimates for realized capital gains are about right. Let me just tell you another fact that I noticed the other day in thinking about this question.

In the year 1969 when the stock market went down, \$30 billion of net capital gains were reported on tax returns. In the prior year when the stock market went up, there were \$33 billion of net capital gains reported. I have absolutely no doubt that, if the stock market rises moderately this year—some people say it will rise a great deal—say 5 or 10 percent, the amount of capital gains reported on capital gains will exceed \$35 billion. On this basis, we could add \$17 billion to the tax base by taxing realized gains in full.

Chairman PROXMIRE. That is only a small part; it is a small part of capital gains?

Mr. PECKMAN. It is only the realized part.

Chairman PROXMIRE. That is only reflected in stock holdings; there are many others?

Mr. PECKMAN. No, we include realized capital gains on real estate as well.

Chairman PROXMIRE. I see.

Then I would like each of you to comment, left to right, beginning with Mr. Stern, on whether you think the capital gains' special benefit should be eliminated and, if so, what should be its tax treatment?

Mr. STERN. Well, as I said, if we are going to have a tax system based on ability to pay, what is the difference between a dollar of profit in capital gains and a dollar of earned income with regard to buying food or shoes or yachts or paying taxes.

There is, of course, the argument about bunched income or taxing in a single year the gains accrued over a period of years; but that, as I understand from the technicians, which I am not, can be easily accommodated with averaging. I would favor taxing capital gains the same as ordinary income with an averaging feature and constructive realization at death.

Chairman PROXMIRE. Mr. Surrey.

Mr. SURREY. Let me just parenthetically say that the figure of 45 percent on capital gains that was used here is erroneous. Even with a minimum tax the rate does not get above 36.5 percent.

Mr. OKNER. Because of the \$25,000.

Mr. SURREY. No, just because of the way the minimum tax works.

Let's assume you were devising an income tax for a country for the first time. The country has never had an income tax and you say: "We want an income tax." I would agree with both of these gentlemen that people would say that capital gains are income just like anything else.

Now, I imagine that somewhere in that discussion somebody would say what will happen if we tax capital gains like other income, will that have an adverse effect on investment and growth under a capitalistic society. My guess is some people would say: "I don't think it will because you are going to allow losses to be deductible in full and, therefore, you are going to really give an incentive to risk-taking," and, consequently, you would probably not harm the economy in any way. Moreover, if you did, you could find devises to stimulate investment.

Others might say, "If your tax rate is too high, people wouldn't want to make risky investments." Practically every government in

the world has taken that position so far. There is no government that taxes capital gains in full under the high rates of income tax.

Mr. STERN. Except the U.S. Government in the early history of the income tax when income tax rates went up as high as 70, 80 percent.

Mr. SURREY. There is no government in the world that does it now.

Chairman PROXMIRE. Some States do; our State does.

Mr. SURREY. But they have far lower rates.

Chairman PROXMIRE. Low compared to the Federal Government; highest among the States.

Mr. SURREY. I say no modern State with high rates. Is that due to general political influence and the like, the power structure in society, or is it due to a genuine worry about what the effects would be on the economic system?

I agree with Mr. Pechman; I doubt whether any country is going to tax capital gains at full 70 percent. If the rates were lower as he suggests and with full loss offsets, then I would think most economists would say to you there is no adverse risk to the economy and capital gains should be taxed in full assuming, of course, you also tax capital gains at death.

Chairman PROXMIRE. Is our country's treatment of capital gains about the same as any other country's?

Mr. SURREY. It is about the same as in England and Canada today. It may be somewhat better, somewhat better than in continental countries.

Chairman PROXMIRE. You say better in what sense?

Mr. SURREY. In that it taxes the gain more.

Chairman PROXMIRE. I see.

Mr. SURREY. It is only in recent years that the United Kingdom has come to the American system and it is only last year that Canada came as far as we have come.

Chairman PROXMIRE. And before that they didn't tax them?

Mr. SURREY. Before that they did not tax stock market capital gains.

Chairman PROXMIRE. Did not tax them at all?

Mr. SURREY. Did not tax them at all. I might also say that Canada has gone one step further and taxed capital gains at death.

Chairman PROXMIRE. Their definition is roughly the same?

Mr. SURREY. Their definition is approximately the same; most capital gains, the greatest percentage, come from the stock market and in the United Kingdom and Canada and the definition is the same.

Mr. PECHMAN. My answer is still the same; I don't think our system would collapse. In fact, I think it would flourish if we taxed income comprehensively and had rates up to no higher than 50 percent. I would hesitate to apply rates in excess of 50 percent to capital gains, but I don't think it would be necessary. Our preferred rate schedule goes up to 44 percent. You have loss offsets and averaging, and if you treat the capital gains transferred at gift or death constructively as realized, you will find our system could handle it very nicely.

Chairman PROXMIRE. Mr. Okner.

Mr. OKNER. I have little to add to the others. Yes, sir, I definitely would be in favor of a comprehensive base, including full taxation of capital gains. I don't think we—the system would collapse. I don't think there would be a fantastic effect on new investment. I don't have

numbers at my fingertips, but no more than 5 or 10 percent of corporate investment comes from external financing today anyhow. Most new investment in corporations comes from retained earnings and depreciation reserves. Capital gains are generated when Man A who may never have seen the company in which he owns stock sells a few pieces of paper that he probably has never even seen to Man B who may not even know what the company does and he never sees the pieces of paper because they are in some stockbroker's safe. And I just cannot accept the arguments on the disastrous results on the rate of new capital investment.

I think they are all sheer nonsense.

Mr. STERN. Can I just add three quick points to that?

One is I think many people tend to consider the preferential treatment of capital gains as written on tablets that came from God, and that it has always been in the American income tax law. It has not. For the first 13 years of our law, including times when rates were as high as 75 or 80 percent. Capital gains were taxed the same as ordinary income.

Chairman PROXMIRE. Isn't that World War I?

Mr. STERN. During World War I; that's right; until 1926, I believe and the country did not disappear down a little hole in Kansas.

Point two: Only 5 percent of corporations' capital needs are met from the stock market; 85 percent come from retained earnings, borrowings, and what was the other factor?

Chairman PROXMIRE. Depreciation reserves.

Mr. STERN. Depreciation reserves.

The third point is that the level of investment does not depend on the rate of capital gains; it depends on economic opportunities and what people think the future is. The amount of realized capital gains has been both high and low, while the capital gains rate has been high, on the one hand, and low, on the other, depending on what business conditions were.

Chairman PROXMIRE. Mr. Surrey, I would like to read an advertisement that frequently appears in the classified section of the Washington Post:

"Alexandria—Tax Shelter—Six-unit apartment house in historic Alexandria with excellent appreciation possibilities. \$57,500. Good financing. Macklin-Hansen Realtors." And gives their phone number.

Do you think that this is an example of the operation of the tax subsidy for the rehabilitation of low-income housing that you speak of in your prepared statement?

Mr. SURREY. Well, it could be, Mr. Chairman, because quite obviously the interest in tax shelters in rehabilitated housing and low-income housing is very great today.

Really, this is how the system works. Supposing you wanted to develop low-income rental housing, or you want to rehabilitate some low-income housing. Under present HUD programs you could get a guaranteed loan, with an interest subsidy that brought the interest down to 1 percent, for practically the total cost of the project.

Chairman PROXMIRE. Using very little of your own money?

Mr. SURREY. Using very little of your own money on this. But you are going to have to work to get the clearance of the loan, arrange for

zoning, and get a builder, and you are going to have to take some risk if the thing does not go through.

How are you, the developer, going to get paid? The Government will give you some tickets called fast depreciation or fast amortization. You have got some tickets now that are labeled fast depreciation or fast amortization and you then find an investment broker and you say, "I have got some of these tickets for sale." He then gets some investors for you and these investors are going to buy these tickets from you. These fast depreciation tickets are very valuable tickets to investors because they bring about large tax losses, paper losses, which offset their other income. So you are going to sell those tickets for about 15 percent of the amount of the mortgage. That is about the going rate in new low-income housing. After you pay off the syndicators or brokers who got those investors for you, the balance of their investment is going to be your profit. The investors in turn are going to make a very handsome return, a discounted return of about 25 percent after taxes under this arrangement.

But you wouldn't have gone into this housing project unless the Government gave you these tickets to sell.

Chairman PROXMIRE. How much risk is involved?

Mr. SURREY. There is some risk on certain low-income housing projects, if the project is not maintained, and so on, but the risk is not commensurate with the returns that are obtained.

Mr. STERN. Isn't that risk taken care of by tax deductions if you lost?

Mr. SURREY. You would get your investment back generally, but you wouldn't have these high profits.

If HUD said, however, "Mr. Developer, all you needed to get out of this was 15 percent of the amount of the mortgage" and if HUD paid that 15 percent, there wouldn't be a need for any tax incentive for low-income housing in the United States. You would then end these tax shelters.

Chairman PROXMIRE. Now, you say that this tax subsidy is probably a waste of Government money because it will not induce an increase in the amount of rehabilitated housing. Is that what we have here, a tax welfare payment?

Mr. SURREY. I think we do, in the sense that you are not going to get any rehabilitated housing that is not HUD subsidized and, consequently, the tax incentive wouldn't bring any additional housing. It will simply move whatever amount of money HUD has decided to allocate to rehabilitated housing but do so on a very expensive basis to the Government and a very handsome investment return to investors.

Chairman PROXMIRE. I worked hard on an amendment to try to change tax exemption and got nowhere; although I made a little progress and have gotten some assistance from some senators, and that is, where you have \$10 million you can sock it away on tax exempts, \$500,000 a year, no income tax now, none. If you buy Wisconsin bonds you don't even pay any State tax either, so you are exempt from both State and Federal income taxes and if I had \$10 million I might be mighty tempted to put those \$10 million in that. It seems to be just a very hard loophole to justify.

Now, you suggest an alternative which would not cost the State and local governments anything. I suggested and proposed an alter-

native that would benefit the State and local government. They would be in better shape but I still couldn't get any support; I got calls from my mayors in Wisconsin. Every time I would go to speak in a town around the State some local official would come in and raise hell with me. This is one thing he was concerned about; he was madder than the dickens that I had proposed something that in his viewpoint eroded the capacity of their little village to raise money on a tax exempt basis and I pointed out they would still have the choice. I did not knock out the alternative of going the tax exempt route; I kept it; but I provided an incentive for going the taxable route because they would be in better shape; their interest would be less. The only loser would be, of course, the banks who invest; it is only the wealthy person who invests in tax exempts; very hard to get it across. I don't know how I could make it more attractive.

Mr. SURREY. Well, I think I understand your frustration, Senator. I really believe, and I hope it is the case, that the climate has changed. I do believe that what you have been urging has finally gotten through. I might add a conference was recently held by the Federal Reserve Banks in Boston last September at which there were representatives of banks, the Investment Bankers Association, all the State and local organizations, and they came to a public announcement that your kind of program for a subsidized elective taxable bond should be adopted; and this was made public.

You also will find there was a resolution at the Governor's Conference that was held in Puerto Rico last September that does open the way for support of your proposal, on an elective basis, with a subsidy high enough so that most, nearly all governments will use it, which is about a 50 percent subsidy.

My guess is if you urge that today you will find a different reception for it.

Chairman PROXMIRE. What they are afraid of is you are going to take an alternative away.

Mr. SURREY. No.

Chairman PROXMIRE. And then reduce the amount of subsidy.

Mr. SURREY. Senator, this consensus in Boston was signed by the representatives of every State and local organization. I would like to include a copy of that statement.

(The following information was supplied for the record:)

BOSTON FED SEMINAR CONSENSUS STRESSES NEED FOR MUNICIPAL BOND  
MARKET REFORM

BOSTON, Sept. 2.—Thirty leading authorities on state and local finance attending a two-day seminar at the Federal Reserve Bank of Boston agreed August 31 that the Federal government should provide state and local governments with an additional method for obtaining access to the credit markets. Although persons attending the seminar represented a great variety of organizations and had a wide range of professional backgrounds, there was general agreement that the market for municipal securities was in need of major reform. They generally agreed that the present market for municipal securities would be unable to supply the funds needed by state and local governments during periods of monetary restraint in the coming decade and that the present method of state and local borrowing created serious inequities in the Federal tax system. In addition, they were concerned that many proposals for reform might bring with them increased Federal control over the capital spending decisions of state and local governments.

Seminar participants reached the following consensus :

"The Federal Government should provide State and local governments with an additional method for obtaining access to the credit markets. Specifically, the group agrees that State and local governments should have the option of issuing fully-taxable obligations (of the character presently tax exempt under the internal revenue code) with the Federal Government obligated to pay to the issuer, without any restrictions, a fixed percentage of the interest cost. This percentage should be set at a level sufficient to encourage widespread use of this option."

Although the group came to a "consensus" on this issue, individual participants made it clear that their personal views did not necessarily represent the official views of their organizations.

President Frank E. Morris of the Federal Reserve Bank of Boston, who presided over the seminar, said that he was pleased that knowledgeable authorities representing such a wide range of organizations could come to a general agreement on this major public policy issue. He expressed the hope that the ideas generated at the seminar could help state and local officials, as well as the Congress, make better judgments on proposed Federal bills dealing with municipal finance. More than a dozen such bills are now being considered by the Senate and/or the House of Representatives.

The seminar participants included the following :

Wayne Anderson, City Manager, Alexandria, Virginia.  
 Meg Armstrong, National Governors' Conference.  
 Donald Beatty, Executive Director, Municipal Finance Officers Association.  
 Irving Beck, Director of Interstate Relations, New England Council.  
 B. Alton Blackwelder, National Association of Counties.  
 Barry Bosworth, The Brookings Institution.  
 John Collins, Consulting Professor of Urban Affairs, Massachusetts Institute of Technology (former Mayor of Boston).  
 Robert W. Eisenmenger, Senior Vice President and Director of Research, Federal Reserve Bank of Boston.  
 Ronold Forbes, Assistant Professor of Finance, State University of New York at Albany.  
 Peter Fortune, Economist, Federal Reserve Bank of Boston.  
 Harvey Galper, Senior Research Staff, The Urban Institute.  
 Richard Gabler, Senior Analyst, Advisory Commission on Intergovernmental Relations.  
 Peter Harkins, Executive Director, Maryland Municipal League, Inc.  
 Patrick Healy, Executive Vice President, National League of Cities.  
 Robert Huefner, Graduate Student, Harvard Business School.  
 Earl Mackey, Assistant Director, National Governors' Conference.  
 Benjamin McKeever, Assistant Counsel, Subcommittee on Housing, House Banking and Currency Committee.  
 Bruce MacLaury, President, Federal Reserve Bank of Minneapolis.  
 Kenneth McLean, Professional Staff Member, United States Senate Committee on Banking, Housing and Urban Affairs.  
 Frank Morris, President, Federal Reserve Bank of Boston.  
 Lawrence Naake, Western Region Representative, National Association of Counties.  
 David Ott, Professor of Economics, Clark University.  
 John Peterson, Municipal Director, Investment Bankers Association of America.  
 Donald Reeb, Associate Professor, State University of New York at Albany.  
 Edward Renshaw, Professor of Economics, State University of New York at Albany.  
 Sally Ronk, Economist, Drexel Firestone.  
 Paul Schneiderman, Economist, Board of Governors of the Federal Reserve System.  
 Stanley Surrey, Jeremiah Smith, Jr., Professor of Law, Harvard University.  
 Paul Tracy, Jr., Vice President, First National City Bank.  
 John Thompson, Vice President, Equitable Securities, Morton & Co.  
 Richard Thompson, Legislative Counsel, National League of Cities and U.S. Conference of Mayors.  
 John Walsh, Director of Finance, City of Hartford, Connecticut.  
 Steven Weiss, Assistant Vice President and Economist, Federal Reserve Bank of Boston.

Mr. PECHMAN. May I add, I am not quite as sanguine as Mr. Surrey is about this agreement. It was an academic exercise, I have talked to some of the people from the financial community who were involved in the meeting and I am not sure they are persuaded.

I hope that in connection with its examination of each one of these subsidies—tax exempt interest, I hope, is one of them—the committee will ask representatives of the financial community and of the industries concerned to come here and testify. I think you will find that the financial community has simply terrorized our Governors, mayors, and county officials about this proposal. Unless you get them before Congress, explain the proposal to them, and ask them why they are against it, and get their support through intellectual activities of that sort, I don't think you are going to succeed.

Mr. SURREY. Joe, I think the climate is changing.

Mr. PECHMAN. I hope so.

Mr. SURREY. The Investment Bankers Association at their conference in Florida last December endorsed that approach.

Chairman PROXMIRE. I am glad to hear it; delighted.

Mr. SURREY. I really think there has been a dramatic change, Senator, which has not yet been felt in the Halls of Congress. If proper discussions were held and proper legislation prepared, I think, the picture would appear different because I think the message you have been preaching has finally come to the right people.

Representative REUSS. So far, gentlemen, most of the discussion has centered on the outrage felt by the average wage earner or middle-class taxpayer when he finds that, by and large, he pays the taxes on his income from whatever source derived, but some millionaire playboy has been getting away with fiscal murder and does not pay his fair share.

In addition to that very important point of equity, isn't there also a most important point to be considered here in terms of the major jurisdiction of this committee, which is full employment without inflation, to wit: if we go on, as we have, with a tax system that develops increasingly greater leaks, aren't we going to get in a situation not unlike that into which we got at the end of the 1920's, where so much of the national income leaked out into the hands of people who neither spent it, because they already had everything they wanted, nor invested it, because with effective consumer demand rather light there just didn't seem to be much point in putting in further capital investment? That is one reason the depression came about in 1929 and the years following.

Without being an alarmist or suggesting we have to have another depression, hasn't our leaky tax system got us into the position where full employment without inflation becomes much harder to achieve, and isn't that an additional and vital reason for doing something about the erosion of the revenue quickly?

Mr. PECHMAN. I would put it in a somewhat different way. I think that, whatever tax system we have, it is conceivable to me that appropriate aggregate monetary and fiscal policies can be run to maintain full employment and price stability. But the major problem that arises—and that is certainly within the jurisdiction of this committee—is that erosion of the tax base and continuous tax reduction make available to the public sector inadequate funds for the social pro-

grams this country needs. Then Congress finds itself in a situation without adequate revenue; and then it thinks about either cutting back social programs or as an alternative raising other revenues which usually are regressive. I am not talking about raising income tax rates; when people talk about raising other revenues they talk about enacting a regressive tax. The danger of continuous erosion of the tax base and continuous reduction of income tax rates is that it leaves the public sector with too little money. We may find ourselves in the position where, because revenues are inadequate, the Congress will seriously be considering the enactment of a national sales tax.

Representative REUSS. Wouldn't you agree, in light of what you just said, that the alternatives to a fair and just tax system are three, none of them any good: (1) tax the poor by a value-added tax to make up the difference; (2) cut back on social programs; cheat the old folks on their food stamps; cut down on the school milk for the kids, both of which the Nixon administration has been up to recently; or (3) turn on the printing presses and borrow heavily, run \$28 billion a year deficits year in, year out, with phony full employment predictions, which is the current fiscal policy of the Nixon administration? That isn't good either.

Mr. PECHMAN. I agree.

Representative REUSS. Any dissent from that, Mr. Stern?

Mr. STERN. Two points: One is that from the point of view of your preoccupation and responsibility in the area of full employment, Congress has just passed what they called a job development credit of several billion dollars to encourage more investment in capital that may be labor-saving and reduce jobs rather than add to jobs.

The other point is—

Representative REUSS. A very good point, if I may interrupt, at a time when we are only using 72 percent of our plant and equipment. If the fraudulently named job development credit does anything, which it may not do, but if it does anything it is going to produce investment which does somebody out of a job because investment that makes additional jobs is not likely to be put in place at a time when only 72 percent of the existing investment is being used. Would that not be correct?

Mr. STERN. Yes.

Two other points: That is typical of the inefficiency of a tax subsidy because it goes to everybody for all of their investments whether they would have undertaken it or not and not to incremental investments.

The other point I wanted to make was if deficits begin to get too big from any point of view, it is possible to put a freeze on or limit direct expenditures; and you and the Executive have some control. In the field of tax expenditures you have none. As a matter of fact, it is the taxpayer who manipulates the whole system and if lots more people decide they want to go into Alexandria tax shelters they, not you, not the President, not the Budget Bureau, decide what the expenditures are going to be and what the deficit is going to be.

Representative REUSS. I would have one last question, probably directed to our friends from the Brookings Institution:

What up-to-date data are there on who gets what out of the income shares of our economy? I am familiar with somewhat antiquated data



which showed that from 1945 to 1965 the income shares of the quintiles didn't change very much. How up to date are we now? I have a feeling in my bones that because of the new loopholes in the tax system, the ultimate income distribution is maybe getting not better, but worse, but who knows?

Mr. OKNER. That is a hard question to answer.

Representative REUSS. It is a pretty important question.

Mr. OKNER. It is a very important question. In a country that is as preoccupied with data and statistics as our own, it is almost criminal that we do not have the kind of information that you are asking about. Tax return information comes in, as you know, a year late; that is, we will get 1971 information filed this April and it then takes almost another year for Internal Revenue to process it and make it available in a form in which it is useful for analysis.

The Census Bureau conducts annual surveys, Current Population Surveys and they are a little bit faster except that their income concept does not include one of our major sources here: capital gains. When they measure income that is not part of their income concept. The Census surveys also use a much smaller sample so they are generally less reliable and very much less reliable up in the higher income ranges.

On the other hand, tax returns data are very much better but they have a major flaw in that they don't include any information on people who are not required to file tax returns, of course. Our new MERGE file is, to my knowledge, the only source that has combined both the census type information and the income tax information. We very shortly are going to urge that certain of the Government agencies concerned consider, not only consider but take the steps necessary, to do the same kind of MERGE procedure that we did for 1966, but based on the 1970 census data. That will at least give us data up through 1969 that will include full information on all families, not just tax-filing families.

It is going to involve a great deal of negotiation; it involves cooperation between both the Census Bureau and the Internal Revenue Service and it is not an easy task.

I would guess that if I started tomorrow negotiating and talking about it, that it would be a year or two at the earliest before we had income information for calendar year 1969 because that is the calendar year that the 1970 census covers.

I just wish we had more and better data, Congressman Reuss.

Representative REUSS. I certainly encourage you to make this inquiry and I observe, in conclusion, that it is a pity that this has to be left to Brookings Institution, while the Treasury, the Census Bureau and Council of Economic Advisers—

Mr. PECHMAN. And very expensive.

Representative REUSS (continuing). And Joint Economic Committee, I suppose have not produced.

Chairman PROXMIRE. You are talking about income distribution?

Representative REUSS. Yes.

Chairman PROXMIRE. The committee has authorized a study of income distribution to cover the last 15 or 20 years; it will be released in the spring and I think you will find it very helpful; very competent people doing it.

Representative REUSS. I am delighted to hear it and we certainly need it.

Chairman PROXMIRE. Lester Throw is the author.

Mr. SURREY. We should not lose sight in this emphasis on the individual that the tax that has been cut back severely by the Congress and especially recently is the corporate income tax. The corporate tax as a percentage of GNP has been declining in this country; the weight of the corporate tax in our whole system has been declining and so on. The outlook for new revenues which are the problems that you mentioned—we shouldn't lose sight of the fact that one of the factors in the dilemma that you bring about is the reduction in the effect of the corporate taxes. If you look at the 1971 Revenue Act that Congress enacted there was a permanent reduction in revenue of close to \$6 billion which went to corporations and individuals over \$15,000; most of it went to corporations.

Only \$1.7 billion went to individuals below \$15,000, and that was largely made up of the low-income allowance which was just a continuing of the pledge that the tax shouldn't apply to people in poverty. So essentially most of this revenue loss, all of it really was in tax subsidies. Consequently, this act was probably one of the worst revenue acts that the Congress has enacted, and clearly from the standpoint of the matters that this committee is going into today.

Mr. OKNER. I might just add that the corporation tax has now dropped to third place in total revenue gathering in this country. Number two is the payroll tax.

Mr. PECHMAN. And it is about to drop to fourth. The property tax may overtake it soon.

Mr. STERN. May I make one additional point on which Mr. Pechman and I are virtually alone, I guess, but that is to urge you to look—urge the members of the press, too, to look at the astounding figure in the Brookings paper on the amount of revenue lost as a result of joint return filing or so-called income splitting.

Now, that is a program in return for which, so far as I know, the Government does not get any quid pro quo but it costs \$21.5 billion. That isn't a tax preference that is written on tablets sent from God, either. It didn't exist in the law until 1948 and really all it does is to give enormous benefits to middle and high income taxpayers, none at all to the poorest married couples, and very little to low income taxpayers.

Chairman PROXMIRE. It provides an incentive for getting and staying married and some people think we need that.

Mr. STERN. Yes, it sure is that but my impression is the divorce rate is increasing despite this incentive; but \$21.5 billion is probably without a doubt the single biggest item in the list that Brookings has come up with and it is almost never considered as a tax preference.

Representative REUSS. You could say it provides incentive to get married, or, put another way, it counters the incentive of the social security laws to live in sin. It comes out about even.

Mr. STERN. But it only provides incentive to middle and upper income people to get married.

Chairman PROXMIRE. And the social security laws only persuaded the poor people to live in sin.

Mr. PECHMAN. I think Mr. Surrey will disagree with Mr. Stern and me on this income splitting point, but I do think it is worth mentioning.

It was originally designed in 1948, when it applied only to married couples. We gradually increased the scope of income splitting by giving half the advantage to heads of households. Then we adopted a special rate structure for single people to give them some of the benefits of income splitting. All we were doing was to pile on tax advantages for married people and single people in the higher brackets. By now it is worth \$21.5 billion, most of which goes to people and families above the \$10,000 income level.

Chairman PROXMIRE. Mr. Surrey, would you agree this is a provision in our tax laws which has no equitable justification at all?

Mr. SURREY. I wouldn't put it that way.

Chairman PROXMIRE. What is the justification?

Mr. SURREY. I don't consider this a tax expenditure; I don't consider this a tax subsidy.

Chairman PROXMIRE. Substantial welfare payment?

Mr. SURREY. No; the question is how you believe married people should be treated vis-a-vis single people. This is an issue on which no government agrees.

Some people have different ideas on this subject but most of the evils that these gentlemen talk about—

Chairman PROXMIRE. You see the only people who really benefit from this are the wealthy married people. The poor or the middle income \$10,000 don't get any benefits.

Mr. SURREY. All you have to do is increase the rates of tax in the upper bracket. I don't disagree with these people that when income splitting came about it worked a tax reduction in the upper brackets. There are hardly any single people involved in these upper brackets, so it is simply a question if you don't like the consequences of our treatment of married couples because it produces a reduction in taxing upper brackets, you don't necessarily have to say eliminate income splitting, because that is a different kind of question, but you can change the rates themselves.

You have to ask yourself, do you want a single person, with, say \$15,000 or \$20,000 of income to be paying the same tax as a married couple with the same amount of income. First make that judgment.

You will also have to ask yourself if a person with \$20,000 marries another person with \$20,000, do you want their total taxes to go up or not? You have to make a judgment on that question.

Most governments find it difficult to answer these questions and they answer them differently.

Whichever way you answer these questions, you can then look back and say now what are the burdens on people in the various brackets. If you found that the judgments you made on treating married people result, as they do in our system, on reducing taxes above \$100,000, where practically everybody is married—

Chairman PROXMIRE. You don't believe that two can live as cheaply as one?

Mr. SURREY. Well, these are judgments on which people agree or disagree.

Mr. STERN. But that is just the point. If two people have to live as cheaply as one, because they are poor they don't get any benefit out of joint-return filing, whereas the people in the over \$1 million group get a \$11,000 a year tax break.

Mr. SURREY. Isn't it true you could retain income splitting but simply increase the rates in the brackets you are talking about.

Mr. STERN. Yes.

Mr. SURREY. So consequently the issue is not income splitting but bracket rates.

Now, getting back to what Senator Proxmire said, it isn't as easy, as I indicated earlier, to make the judgment as to what should be the tax on a single person vis-a-vis a married couple at the same level of income and people are going to differ on that question.

Mr. PECHMAN. I have examined these relative tax liabilities and I am not nearly as concerned about the penalty on marriage that would occur, if we eliminated the benefits of income splitting. Income splitting is a neat device to equalize the tax burdens of married couples in different States. I would not eliminate income splitting. What I would do is to remove the tax advantages of income splitting. The real question is, as Mr. Surrey suggested, do you want a married couple with \$50,000 of income to pay exactly twice the tax of two single people with \$25,000 of income each? In my scale of values, I think that the married couple with \$50,000 of income should pay somewhat more tax than the two single people combined. I think this would be a better tax system and also it would not provide the mechanism for additional tax benefits to the wealthy, which now aggregates \$21 billion.

Mr. SURREY. But that last point could be taken care of by raising rates in those brackets.

Mr. PECHMAN. But Congress does not do it that way; it will continue to erode the tax system by giving more and more benefits to higher income people.

Mr. SURREY. This is a different area than the tax expenditure subsidies we are dealing with.

Mr. PECHMAN. It may be a different line, but it happens to be the biggest single revenue loss from what I call the eroding features of the tax law.

Mr. STERN. With \$21 billion of \$21.5 billion going to the over \$25,000 group.

Chairman PROXMIRE. One of the things you are overlooking is the possibility of reducing some of our unjustified expenditures and wasteful expenditures and establishing priorities more clearly. Now maybe this is unrealistic but this is something that some of us feel we are spending a whale of a lot too much in the military area. I think the present space proposals are going to be fantastically expensive, \$6.5 billion; the space shuttle is beginning; it has to cost \$140 billion over the next 13 years in order to justify it and there are many other areas where I think we could cut expenditures and do what we should do; but I don't want to get into that because that isn't pertinent to what we are talking about.

I think, if we are going to be realistic, however, I think we are taking the first step in these hearings, especially here this morning, in recognizing that we have not been successful before because we have not had an awareness, an understanding, an appreciation of the impact either

of tax expenditures or many other subsidies, and that what we need is to publicize the effect of this.

We need in the first place a solid, expert, acceptable analysis of what these cost. Then we need some kind of an estimate of benefit; and then we want to know, of course, whether the benefits exceed the costs.

If they do not, what alternatives are available? Are they practical? Will they work? Then it seems to me that we have to get some institutional way of having this done in a regular manner and in an expert manner.

Now, Mr. Houthakker suggested that we have a joint committee in order to do this, like the Joint Economic Committee. It was suggested by Mr. Shoup, that we should have a monitoring board, a separate agency do it. It seems to me that with the experience I have had trying to get money for this committee and additional functions for this committee, and trying to get another committee established in one case it might be more practicable to let the GAO do the staff work, make the analysis and then have hearings perhaps before this committee or a special subcommittee of this committee which we would create which would not require going to an appropriations committee for more funds, every year require a report by the GAO on every one of the major subsidy programs, including tax expenditures, to give us this information.

Do you gentlemen have other thoughts on this? Which do you prefer? What kind of an approach do you think would be most realistic and practical?

Mr. Stern.

Mr. STERN. I pass to the experts.

Chairman PROXMIRE. Mr. Surrey.

Mr. SURREY. Well, the real burden of this should fall on the regular committees of the Congress. I mean there is absolutely no reason why these regular committees of the Congress shouldn't be raising these questions with the departments over which they have oversight to justify these tax expenditures. It also falls on the tax committees and they should be asking the Treasury and the departments to justify them.

I would be a little concerned I think, the same way you are, Mr. Chairman, about adding another committee structure to problems that really are now divided between the tax and expenditure committees of Congress with your committee as the catalyst—

Chairman PROXMIRE. You see, one of the reasons I think we have to escape from the tax writing committees on this, and I think they might agree, is this has much broader implications than revenue raising and the kinds of analysis that is required; neither committee has the staff capability now to do it. It would require some judgments and so forth to be made and would involve perhaps, after all we are simply discussing the tax aspects today, but there is a great deal of subsidy expenditures in other areas.

Mr. SURREY. Yes, but what I am talking about—I was talking about the tax aspect. For example, there is no reason why Banking and Currency should not ask HUD to suggest alternatives for the present tax expenditures in housing.

Chairman PROXMIRE. I want to do something that will get results. We are not doing it now.

Mr. STERN. Wouldn't one of the best ways be to add to the budget of each department an amount of tax expenditures attributable to it? It is hard to allocate them in some cases but if the Interior Department had to account among other priorities for \$1.3 billion or \$1.6 billion of oil exploration incentives, and if HUD had to justify the \$7 or \$8 billion in housing subsidies, that would be a very material increase in HUD's budget and would focus this very strongly, both, I think, at the Budget Bureau level and at the congressional level.

Mr. SURREY. When you hold hearings on the budget, you should ask for this information.

Mr. PECHMAN. I think the committee could help in another way, since nobody publishes this table—except me, in a statistical appendix to my book, "Federal Tax Policy." After the budget is submitted, the committee ought to put out a table of tax expenditures and subsidies, distribute them by functional categories and show the ratio of tax expenditures to budget expenditures for each category.

Chairman PROXMIRE. You say this committee?

Mr. PECHMAN. Yes.

Chairman PROXMIRE. Fine.

Mr. PECHMAN. You can do it very cheaply and—

Chairman PROXMIRE. We will do it cheaply. We will do it.

Mr. PECHMAN (continuing). I think it can be done very, very easily.

Chairman PROXMIRE. And then require the Treasury to submit for each new tax proposal or amendment the effects, the costs, the benefits, and so forth?

Mr. PECHMAN. Indeed. I would have them not only do that—that is, estimate the direct revenue costs—but also the other costs imposed on society by some of the tax expenditures and direct subsidies. For example, many of the subsidies that are given to airlines in general aviation impose costs on other people which are not measured by the expenditures on the subsidies directly. We are trying to do this in Brookings on particular programs and several of our staff members will be testifying to the committee on these matters. It is a very complicated pattern, but you should require Government agencies to estimate not only direct costs but also total welfare costs.

Mr. STERN. Can the Treasury in the case of any new tax program submit estimates of the effect by income class as you have done?

Mr. PECHMAN. Sure; if it devotes enough resources to it.

Mr. STERN. That would seem to me something worthwhile asking for.

Mr. OKNER. Let's not be unfair. There are estimates by broad income classes.

Mr. STERN. As to certain things but as to special features now—

Mr. OKNER. Not everything.

Chairman PROXMIRE. I think we should end this excellent testimony today with the emphasis Mr. Stern uses to end his testimony. He says we have drifted so far from the guidelines of the 16th amendment, which empowered Congress to levy taxes on incomes, from whatever source derived, because the public itself has not fully understood what Congress has done in the tax laws.

I think that that is true, the public just doesn't know. They would support reform if they did. But your testimony will be very valuable

in educating them, and moving toward reform, and I want to thank you very, very much on behalf of the subcommittee. I think you performed a great service on behalf of the committee and the Congress. This testimony has been thoughtful, stimulating and helpful. Thank you very, very much.

The subcommittee will stand in recess until Monday morning when we meet in this room to hear the Honorable Fred Harris, Professor Posner of the University of Chicago, and Prof. Murray Weidenbaum of Washington University, at 10 o'clock.

(Whereupon, at 12:55 p.m., the subcommittee was adjourned, to reconvene at 10 a.m., Monday, January 17, 1972.)

# THE ECONOMICS OF FEDERAL SUBSIDY PROGRAMS

MONDAY, JANUARY 17, 1972

CONGRESS OF THE UNITED STATES,  
SUBCOMMITTEE ON PRIORITIES AND  
ECONOMY IN GOVERNMENT OF THE  
JOINT ECONOMIC COMMITTEE,  
*Washington, D.C.*

The subcommittee met, pursuant to recess, at 10 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the subcommittee) presiding.

Present: Senator Proxmire; and Representatives Reuss and Blackburn.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Jerry J. Jasinowski, research economist; George D. Krumbhaar, Jr., minority counsel; and Walter B. Laessig, economist for the minority.

## OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The subcommittee will come to order.

Today we begin our third day of hearings into the Federal subsidy system, a system of special benefits that have been allowed to exist in the shadows of public policy. As we said at the beginning of our first day, the purpose of the hearings is to bring to light the pervasive influence of the subsidies on the private economy, to study the nature of that influence, to ascertain the costs and benefits of particular subsidies, and to see what might be done to bring subsidies and other special benefits under control. As we said then, we are interested in determining how well the subsidy system and particular subsidies serve the average citizen.

The need for such a review was established by a Joint Economic Committee staff study released prior to the hearings. In addition to determining that Federal subsidies cost the taxpayer at least \$63 billion a year in fiscal 1970, and undoubtedly will cost more in 1971, and are likely to cost still more in the present year, the staff study also found that many subsidies were hidden from public scrutiny, that there was little information about how these subsidies affect private markets, that no one really knows who benefits from these programs, and that there appears to be a bias toward producer subsidies, as well as other findings.

In our first 2 days of hearings all witnesses agreed that the subsidy system was out of control, much of it hidden from the public, and that the system was in great need of indepth review and analysis. All agreed that every effort should be made to reform the budget so that



the costs of Federal subsidies are publicly identified, especially tax and credit subsidies.

Proposals by Mr. Carl Shoup and Mr. Hendrik Houthakker, to establish a review board to critically evaluate subsidies and other special benefits, were endorsed by other witnesses. That board, incidentally, was to be either a new congressional committee or a subcommittee of this committee.

Finally, all witnesses agreed that such a review mechanism should be made a legislative requirement similar to the West German subsidy report.

In our second day of hearings, we received dramatic evidence that most of the tax subsidies redistribute income to the rich. For example, taxpayers with incomes over \$1 million a year receive \$641,000 in annual capital gains benefits while taxpayers with incomes between \$5,000 and \$10,000 a year receive \$8—not \$8,000, but \$8—in annual capital gains benefits.

The tax subsidy for interest-free bonds has a similar effect, providing annual benefits of \$36,000 to those with yearly incomes in excess of \$1 million, while providing only 80 cents—80 cents—to the average taxpayer with a yearly income of \$10,000. These are just two illustrations.

So we have had excellent testimony that will be most useful in evaluating the mammoth subsidy system as well as particular subsidy provisions.

Today we wish to expand our inquiry and give particular attention to the somewhat diverse subjects of the politics of subsidies, credit subsidies, and regulatory subsidies.

Credit subsidies may be the most complicated and among the most hidden of all the financial forms of a subsidy. Credit subsidies take the form of government loans at less than the government or market rate, as cash grants, as loan guarantees and insurance schemes, and as so-called soft loans. But few of these programs are labeled and evaluated as subsidies and there is widespread misconception that credit programs don't cost the government anything.

Yet both the staff study and Mr. Weidenbaum's testimony show fiscal 1970 credit subsidies of \$4 to \$5 billion. Today we will want to examine why these subsidies are not generally known and how we can bring them under better control.

"Regulatory subsidies" is a term coined in the staff study to describe the case of where government does not directly pay the subsidy itself but uses its considerable power to regulate a private market in a way that causes income and wealth to be transferred from one private party to another. In the case of the oil import quota, for example, government power is used to transfer income and wealth; that is, to confer a subsidy, from oil consumers to oil producers. We know very little about this form of subsidy and hope to learn more today.

I might say that Richard Posner, the distinguished professor of law at the University of Chicago, had to cancel at the last minute so he unfortunately could not be with us today.

I request that his prepared statement be placed in the record at the end of my opening statement.

Finally, there is the question—we are going to hear first Senator Fred Harris—of the politics of subsidies. In all candor, as was said in

the staff study, it should be acknowledged that use of the subsidy device as a political instrument has also contributed to our lack of knowledge about it. One needs only to support a program that seems to provide assistance to the special group seeking aid.

The political incentives are to keep the arguments for the assistance vague and simple, making many references to the national interest, few references to careful analysis, and preferably not even referring to the assistance as a subsidy. The direct recipient of the assistance probably will not analyze it carefully enough to determine if it works and neither will anyone else, and the program will simply blend in with the rest of the subsidy scene.

But such a simplistic approach does not lead to policy choices that improve the efficiency and general welfare of the economy. We need both facts and hard analysis if we are to use the subsidy instrument intelligently. We look forward to Senator Harris' analysis and recommendations in this important—some may say dominant—dimension of Federal subsidy and special benefit programs.

(The prepared statement of Mr. Posner, referred to in Chairman Proxmire's opening statement, follows:)

PREPARED STATEMENT OF RICHARD A. POSNER, PROFESSOR, UNIVERSITY OF CHICAGO  
LAW SCHOOL

#### REGULATORY SUBSIDIES

My name is Richard A. Posner, and I am Professor of Law at the University of Chicago. I have taught and written in the regulated-industries field, and specifically about regulatory subsidies, the subject on which I have been asked to testify today. I have submitted a paper to the staff of the Committee, based on my article, "Taxation by Regulation," which appeared in the Spring 1971 issue of the *Bell Journal of Economics and Management Science* (volume 2, page 22). In this testimony I shall endeavor to present the highlights of my work in this area.

A "regulatory subsidy," as I shall use the term, is the product of a pricing structure under which some customers of a firm are permitted to purchase at prices below the cost of supplying them, while others are forced to pay prices above the cost of supplying them in order to make up the losses sustained on the sales to the favored group. The first group is subsidized by the second; the first group receives a benefit (in cheaper goods) at the expense of the members of the second group, who correspond to the taxpayers who defray the cost of explicit subsidies. The transfer of wealth that results from the maintenance of a pricing structure such as I have described is correctly regarded as a subsidy: it is an alteration in the normal market determination of income distribution and resource allocation, an alteration brought about by governmental intervention, for it is easy to show that, in a free market, pricing subsidies would be eliminated by competition. It comes as no surprise, therefore, that such subsidies are common in regulated industries and public services (such as the postal service) and uncommon elsewhere. Hence the term "regulatory subsidy."

A good example of the practice is provided by intercity passenger railroad service. Long provided at a loss by the railroads which they recouped, as best they could, out of freight revenues, it has now been nationalized—thereby shifting the burden of the subsidy from the railroad shipper to the general taxpayer. There are many other examples in the transportation and communications industries. Shippers of agricultural commodities on the railroads receive highly favorable rates that cannot be justified by cost or demand factors and that result in exorbitant rates to other shippers. Airline rates are pegged to distance with little or no weight given to cost differences among different routes, with the result that passengers on dense routes, where unit costs are low due to favorable load factors, subsidize passengers on sparse routes, where unit costs are much higher; route density factors are also ignored in the pricing of telephone service. AT&T provides electronic interconnection to the National Educational Television network below cost, the deficit being made up by other users of AT&T's services.

Broadcasters are required to provide unremunerative news and public-affairs programming; advertisers pick up the tab in the form of higher rates for commercial time. Cable-television companies are commonly required to dedicate channels free of charge to municipalities for various public functions, and their subscribers pay for this service (without necessarily enjoying its benefits) in the form of higher subscription rates. These examples could be multiplied, and extended to other industries. For instance the fact that liability insurance for high-risk automobile drivers is in many states written at a loss: safer drivers subsidize the less safe.

Now there are, it seems to me, many objections to the regulatory subsidy, although I do not wish to be understood as implying that they are necessarily worse than other subsidies. The major objections are the following:

1. They are inefficient. They force prices in some markets below cost (thereby inducing the consumer to substitute the subsidized product for others that may cost society less to produce) and force prices above cost in other markets (thereby inducing the consumer to subsidize other products that may cost society more to produce). They create a secondary inefficiency: they foster monopoly. I said earlier that competition, if permitted to operate, would eliminate a pricing structure under which some customers received service below cost and others had to pay exorbitant rates. This is because sellers would have an incentive to bid customers in the higher-priced market away from each other by offering a slightly lower price, until eventually price was driven down to cost (including therein a reasonable allowance for profit). Hence the maintenance of a regulatory subsidy requires that the regulatory agency prevent existing sellers from competing in the higher-priced market and control entry into that market by new competitors, who will be attracted by a favorable price-cost spread. In fact we observe that regulatory agencies normally control entry and often administer entry control so as to assure continued monopoly.

2. They are expensive to enforce. I have already noted that the implementation of a system of regulatory subsidies entails the establishment of an administrative apparatus for control over entry. In addition, there is a serious problem of evasion by the regulated firm. If it finds the provision of unremunerative service irksome (as well it may), it may try to terminate it by drastically reducing the quality of service and then citing the resulting fall in demand as evidence that the public no longer wants it. Since the public is not paying the full cost of the service, it has a natural tendency to demand a very high and correspondingly costly level of service. Specifying an appropriate level involves an essentially arbitrary judgment. Evidently degradation of service has played an important role in the termination of railroad passenger operations. It is very difficult for regulatory agencies to cope successfully with this problem, which is evidently a general attribute of regulatory subsidies.

3. They complicate an already barely manageable regulatory process. Because there is no objective basis for comparing the social benefits of a subsidy program with those of efficient prices and free entry, an agency concerned with subsidizing worthy groups through manipulation of pricing structures is deprived of a clear-cut standard for resolving controversies over pricing and entry. Clear and definite standards are necessary to tolerable regulation. Without a definite standard at the agency level, moreover, judicial review, which is a potentially important check on regulatory abuses, is likely to be ineffectual: the agency can give a plausible justification for any result. Multiple and conflicting standards may also breed corruption.

4. They are insulated from effective public scrutiny. Regulatory subsidies enjoy a very low visibility, which impedes responsible review. The amounts, recipients, and objectives of direct subsidies are ordinarily specifically stated and formally approved by a legislative body. This is not the case with regulatory subsidies. They are rarely quantified: the recipient class is, at best, vaguely defined; objectives are rarely discussed, although occasionally alluded to. The process of creation is diffuse and obscure—the result of scattered decisions dealing with pricing and entry disputes, and often of informal, private, even tacit understandings between the personnel of the regulatory agency and the regulated firms. Since information is not a free good, a subsidy program so nearly invisible is less apt to be challenged, even if devoid of social value, than a more visible program.

5. They are capricious in their incidence. It comes as no surprise, after the previous point, that regulatory subsidies generally lack a convincing social or economic justification. A regulatory subsidy imposes a tax on consumers (the

purchasers forced to pay a higher price to defray below-cost service to other purchasers from the regulated firm)—a form of taxation that would ordinarily be considered highly regressive—in order, typically, to benefit high-income groups whose deservedness of subsidy is far from apparent.

I do not infer from these observations that regulatory subsidies should be abolished, even if that were a realistic goal. The problems reviewed above afflict other subsidies—the oil-import quota, for example, is inefficient, hidden, capricious, and costly to administer. It is unfortunately not clear that regulatory subsidies are always, or most of the time, more pernicious than direct subsidies.

At this stage, therefore, I content myself with suggesting some limited but I think worthwhile reforms:

1. No regulatory subsidies for national defense. The regulatory subsidy is apparently a fairly common device for subsidizing defense needs. An example is the Defense Department's support for the construction of additional transatlantic communications cables that many observers (including myself) doubt can be justified on purely commercial grounds and that result in higher rates to telephone users. This type of regulatory subsidy is peculiarly insulated from responsible review because of the regulatory agencies' inexperience with defense policy and questions. I am not arguing that less money should be spent on national defense, but only that regulatory subsidies are an inappropriate way of appropriating defense moneys.

2. Identification, explanation, quantification. Agencies and reviewing courts should in my judgment insist, in proceedings where the maintenance of regulatory subsidies is in issue, that the amount and cost of the subsidy, together with the identity of the recipients and of the payors and a statement of the social purposes desired to be accomplished by the subsidy, be placed in the public record. This might eliminate some of the more captious instances of the practice and would at least bring an important issue of public policy into the open.

3. Choice of best method. Accepting the decision to subsidize a service and to impose the cost on other customers of the regulated firm, it does not follow that the only way to achieving this goal is to control prices, entry, abandonments, and so forth in the fashion of public utility or common carrier regulation. For example, an explicit excise tax (such as the percentage-of-gross-receipts fee in many cable-television franchises), with the proceeds earmarked for the service that is to be subsidized, seems preferable to the more usual kind of regulatory subsidy (monopoly pricing in one market to generate the profits necessary to offset the losses sustained in providing the subsidy) because it does not require a limitation of entry. A likely reason why alternatives such as this are rarely considered is that most regulatory agencies lack authority to impose an explicit tax or other fee. In franchise regulation, as the case of cable television suggests, this option is open. Perhaps, therefore, a modest enlargement of the taxing power of regulatory agencies, designed to permit them to exact a uniform and limited fee from any firm desiring to enter a regulated market, imposed in lieu of other regulatory controls, would be a step in the right direction.

Chairman PROXMIER. Senator Harris, do you want to come to the table in front? We would be delighted to hear from you.

Senator Harris is an old friend of this committee and this Senator and he has brought a great deal of intelligence and thoughtfulness and a very great drive for the broad public interest to these questions. We are delighted to have you, Senator Harris. Go right ahead.

#### STATEMENT OF HON. FRED R. HARRIS, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

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

I want to begin by expressing my appreciation to you and this committee for what I think are highly important and pace-setting studies of this whole subsidy question. The superb study you have prepared points out that Federal subsidy programs now cost the American people \$63 billion plus, and indications are that this is just the tip of the iceberg.

Clearly, the stakes are high. The amounts involved are colossal. The numbers of people concerned are enormous.

We all would think that in this situation the Congress would take the greatest possible care in creating or continuing a subsidy program; but we also know that is not the case. The legislative process for considering subsidies is a national disgrace. Programs are casually established and irresponsibly continued with little attention given either to the economic effects for the Nation or the ultimate cost to the taxpayer.

Economists scheduled to testify before this committee will describe the economics of subsidies programs—why they may be bad and why they may be good in some instances.

I am here to discuss primarily the politics of subsidies, why they are established, why they are continued and why they are protected.

I also would like to suggest some areas for further investigation or at least to give my own priorities on further areas for investigation by the committee and to outline my general views on reform.

First, to the politics of the subsidies programs. I would like to begin with an assertion: Subsidies are to modern politics what patronage was to the politics of the 19th century. Subsidies, in other words, are the lifeblood, tainted to be sure, of our electoral system; and this is precisely the reason why it is so hard to eliminate a subsidy once established.

In the 19th century Government involvement in economic affairs was but a shadow of its present extent. Certainly there were financial advantages to be gained if a particular party controlled the Congress or the Presidency. Such obvious examples as congressional land grants for building the railroads or public works like interstate canals come to mind.

But the real lure of political life was the spoils system. If an individual party captured the Presidency or the Congress there were jobs aplenty for the many who had contributed to the effort. The old rascals were thrown out so that new rascals could take their place.

The civil service reform in the late 19th century ended most of these abuses. Nevertheless, many of our historians and journalists, suffering from a sort of historical hangover, continue to focus on politics primarily from the standpoint of who gets what job in the wake of victory and how he uses or misuses his position for financial gain. But the real raid on the public treasury, which makes mere graft pale by comparison, is taking place elsewhere.

Today the public is finally beginning to wake up to the fact that getting elected to public office costs an enormous amount of money. The nonprofit, nonpartisan Citizens Research Foundation of Princeton, N.J., has estimated that it took \$100 million to conduct the 1968 presidential election. An additional \$200 million was estimated to have been spent by all other candidates and committees at all levels of government. The grand total, \$300 million, was half again as much as was presumed to have been spent just 4 years earlier, in 1964. The figure in 1972 will even be higher.

Now the overwhelming portion of this money—and I want to emphasize this—is not given in order to force candidates to support special-interest legislation which otherwise these candidates would re-

ject. With our honeycomb system of endless subsidies, most of the special-interest legislation is already on the books.

The monied interests in this country therefore give to political parties not so much in order to gain new advantages as in order to protect existing advantages. They give sometimes to both parties in order to insure that whoever is the winner, special-interest subsidies, however outdated, will never be touched; and politicians, who always face a long list of significant things they may do, move on to other less controversial issues.

In effect, then, this combination of heavy Government involvement in the economy and of a scandalous system of campaign financing makes it highly unlikely that the Congress will ever embark on a course of fundamental reform. The two set the limits to what is politically permissible.

Most politicians know that what I am saying is true; but it may be useful for others who do not for me to cite a few examples for the record:

The study which this committee has produced notes that the capital gains loophole puts a cool \$7 billion—and recent testimony before your committee suggests as much as \$13 billion—in the hands of those rich people in our society who primarily benefit from this tax advantage. And as you just pointed out, Mr. Chairman, that tax advantage primarily goes to rich people.

Now liberals do not always get that much money from the oil industry, and it is therefore not too difficult, unless one is from a State like Oklahoma or Texas, to talk about doing something about the oil depletion allowance. Obviously the oil industry receives unfair tax treatment through import quota subsidies and there are other politically appealing subsidies which also demand correction. But liberals do get a lot of money from Wall Street.

It was, therefore, no surprise that Joseph Duffey, former president of the Americans for Democratic Action, who ran for U.S. Senator from Connecticut in 1968, chilled some of his best contributors to the point of zipping tight their pocketbooks, when he included reform of the capital gains tax in his list of tax reforms needed.

During my campaign for the Democratic nomination, one of my principle backers became increasingly alienated by my talk about decentralizing the shared monopolies which dominate 35 percent of American industry and which artificially set prices far above competitive market levels, perhaps as much as 20 percent. He preferred safe subjects such as drugs or the war in Vietnam that everyone is against.

In 1968, presidential candidate Hubert Humphrey was in grave need of large sums of money to buy national TV advertising. As you know, I was involved in that campaign. As Murray A. Seger subsequently reported in the Los Angeles Times, one source of cash was a group of millionaires in the Houston Petroleum Club; but they demanded, according to Seger, that Senator Humphrey endorse the oil depletion allowance.

To his great credit, Senator Humphrey refused to do so on the grounds that any new President would need to undertake a program of tax reform and that the oil depletion allowance was a prime candidate for reform. But some weeks later the Republican candidate en-

dorsed the oil depletion allowance and subsequently received large amounts of cash from Texas oilmen.

I do not think it is entirely an accident that this administration has not seen fit to undertake a campaign of tax reform which Senator Humphrey felt any new President would need to propose. And I might say that intertwined with this issue in the appointment of John Connally to be Secretary of the Treasury. I think he was involved in getting some of those oilmen to give some money to President Nixon rather than helping on contributions for Vice President Humphrey, and I think it is no accident that, under Secretary Connally and President Nixon, we are going to see not tax reform, not an effort to make the tax system more fair, but probably an attempt to ask the people to pay a sales tax not based upon ability to pay.

The political phenomenon I am describing also explains why our Government is approaching the kind of paralysis which many of us fear is approaching.

For now it is very difficult to get American politicians, including many who are quite liberal, to advocate more than just tinkering with fundamental wrongs or simply adding a little more to existing New Deal-type programs. If one group is gaining unfair advantage, the reaction of most legislators is not to end that injustice, but to seek similar advantages for their own constituents. We see this everywhere.

If the trucking industry gets a subsidy from the highway trust fund, Congress' answer is not to end that subsidy but to grant comparable subsidies to other modes of transportation. If the oil industry gets a depletion allowance, the response is not to end that abuse but to pass the abuse on to other extractive industries as well, and so on. The whole process snowballs until we end up with \$63 billion plus in subsidy programs and with a government that begins to stagger and fall from its own weight.

Perhaps the most blatant example of this political horsetrading occurred this year during congressional consideration of the Revenue Act of 1971. This act contained the so-called DISC loophole which I, and you, Mr. Chairman, and others fought, a loophole which enables the U.S. based firms exporting abroad to receive a massive tax reduction on their profits. And in this regard I believe it is manifestly true, and several tax lawyers for corporations that will reap the windfall of this loophole would say, "If you put us on the stand and under oath we were asked to say whether in order to get this extra money our clients had to do anything different from what they would do in any case, we would have to testify that they do not." So what we are going to wind up doing is to give a bunch of giant corporations public money without requiring them to change their public behavior in any definitive way.

In defending this new loophole, Secretary Connally noted that U.S. firms with subsidiaries abroad often under present law are able to avoid payment of U.S. taxes of their foreign earnings because of existing loopholes, the so-called deferral provision.

He argued that we needed to offer comparable tax advantages through the DISC to U.S. firms without foreign subsidiaries; otherwise, they might at some point be encouraged to locate abroad. It apparently never occurred to the administration or, unfortunately,

to most of the Congress that this was an extraordinary tax doctrine. In brief, that an existing tax loophole should justify not a renewed attempt at reform but the introduction of yet another source of tax abuse.

So what's to be done? One obvious answer is urgent reform of campaign spending, a subject which the Senate has already debated in the recent past. There are other answers, however, which I would like to mention today.

In 1970, in a letter to Soviet leaders, the great Russian novelist, Alexander Solzhenitsyn, pointed out the importance to decent government of what he called "glasnost." "Glasnost" is the Russian word for publicity. Solzhenitsyn's point was that governments are always afraid to do in public what they willingly do in private. So the answer to better government is almost always more and better information for the people.

I believe that the new Populist spirit in this country is one that is going to dominate the politics of this country in the coming decade, and I don't think many politicians have yet caught on to this point. One aspect of that—I think a basic aspect—is pointed out by the revelations of the Anderson papers and by the revelations of the Ellsberg papers and by other examples that could be given. People are, more and more going to demand to know what is going on in government. This is true whether the subject is foreign affairs or has to do with the conduct of the Vietnam war or whether it is congressional consideration of subsidy programs. In every such instance in a government which depends upon consent of the governed, we ought to be moving toward greater public knowledge of the facts necessary for consent.

We must open up our system of government to public inspection and some very simple reform would help.

First, there is no reason why our people should not know who in our country receives subsidy payments. We all remember how the pressure for tax reform mounted as soon as it became known that nearly 200 millionaires were not paying Federal income taxes. I believe that we would see a similar reaction on the part of the American people—we would get a vigorous push for real tax reform—if they realized what percentage of each subsidy went to certain groups in our society.

I would, therefore, urge that every subsidy be analyzed in terms of the monetary benefit to different income brackets. For example, we should know how much of the \$7 billion to \$13 billion that slips through the capital gains loophole goes to the upper 10 percent of the income bracket, the upper 20 percent and so on. In the case of business subsidies we should know what proportion of the benefits go to the top 100 firms, top 200 firms and so on. Armed with this kind of shorthand information, journalists and commentators, voters and political opponents would be able to press politicians and the political system to address themselves an itself to the real issues, at last to end abuses instead of seeking new programs which compensate for them.

Second, markup sessions in congressional committees must be public. The House Education and Labor Committee has already adopted this practice, and I believe, other committees in Congress should follow this example.



Open sessions might end some of the political horsetrading which now goes on to the detriment of the general public, the system of each committee member getting special-interest amendments adopted regardless of the effect on the national interest.

Third, we should set ourselves an entirely different objective. Now in dealing with economic dislocations in our economy, we attempt to calm and very seldom to heal. By this I mean we provide compensation through subsidy payments but we do not attempt to insist on fundamental changes which will make the subsidy at some point unnecessary, or we do that very seldom.

I believe that in all subsidy legislation the Congress should call for reform measures leading to the early death of the subsidy which it has been necessary to create.

Fourth, we need a congressional overseer and I believe you have already heard, as you mentioned in your opening statement, a very good proposal for either a separate committee or what probably would be better, and more effective, a subcommittee of this committee, to hold annual oversight hearings on all subsidy programs in effect 5 years or more and to report to the Congress on their effectiveness and on steps taken toward their ultimate elimination.

This oversight committee, in its annual report, should also rank the subsidies in the order of their desirability so that other Members of Congress may know which subsidies it would be easiest to eliminate. If complete elimination is not possible, the committee might regularly explain why.

Fifth, one of America's leading tax authorities, Joseph Pechman, has pointed out in his book, "Federal Tax Policy," that the Congress' two tax committees traditionally are exposed to a drumfire of arguments for special tax advantages. I might say, as a member of one of those committees—the Senate Finance Committee—that this is certainly true. As a matter of fact, the House Ways and Means Committee has a kind of special sort of arrangement whereby each member of the committee at some time during the year can attach an amendment, some kind of special tax amendment, as I understand it, with sort of automatic approval by the other members of the committee.

We don't have anything that institutionalized in the Senate Finance Committee, but it probably works out about the same; in fact the members of the Senate Finance Committee probably get more than one.

Difficult though it is to believe, the salaries of lobbyists who carry out this attack are actually tax deductible for the companies concerned. Since the corporate tax rate is 48 percent, this means you and I effectively subsidize this activity which is clearly often not in the national interest. Meanwhile there is no one to represent the national interest. The Secretary of Treasury has to assume this role but we all know for political reasons he himself is seldom qualified to speak out without restraint.

We need to encourage the formation of more organizations like Common Cause and Ralph Nader's Public Interest Research Group which do look after less partisan interests. And we need to end the tax subsidy which we now give business to lobby before the Congress for special-interest legislation.

Between 1918 and 1962, businesses were not allowed to deduct lobbying expenses from their taxable income. It is imperative that we return

to that practice. To encourage the formation of more groups like Common Cause, we need to provide, I think, a modest tax credit, perhaps \$25, to every taxpayer who agrees to contribute this amount to any organization officially registered as a lobbyist and agreeing to certain disclosure requirements. This money could go to organizations from the National Association of Manufacturers to new public interest groups which would form as a result of this law.

I believe this type of reform would permit the public for the first time in our history to speak to the Congress in a voice as loud as that of the special interest seekers or protectors and, particularly now, of corporations that are able to lobby at taxpayers' expense.

To make our parties more relevant, we might also stipulate that this tax credit could go either to the political parties or to public interest lobbying organizations.

Again, I would like to commend this committee and its staff for the excellent study that has been prepared and that is now underway in regard to subsidies. I want to emphasize in closing, however, four principal areas of subsidy which are of particular interest to me and which I think demand fundamental reform:

First and most obvious, of course, is the subsidy, or are the subsidies that result from tariff laws, import quota laws and the tax laws generally. For example, as the President's Cabinet Task Force suggested, we ought to end our support of the oil import quota system and replace that with a tariff system which would be much more fair to the consumer and more in line with the national interest. Reform also involves, of course, across-the-board reforms insofar as capital gains, oil depletion and other related subsidies are concerned; and I think here it is really important in considering the tax laws to understand that our present tax code probably is the greatest subsidy that we give to rich people in our society.

If we tax not on the basis of ability to pay but, as we do so much, by means of the property tax at local and State levels, the sales tax at local and State levels—and now we are apparently going to get a recommendation for a sales tax at the national level—then given the unprogressive nature of our income tax laws, all of this works out to be an enormous subsidy for rich people. We do not tax them on their ability to pay and we overtax a great many other people through the unprogressive Federal income tax and through property and sales taxes. It seems to me we have here the clear need for reform.

There are areas involving subsidies, though, that are probably less obvious and that is particularly in regard to Government policy and the free enterprise system.

We have what we are pleased to call the free enterprise system which through free competition is supposed to provide the American consumer with the highest quality goods at the cheapest price. This is the idea and I believe we should agree that departures from it which governmental policy either fails to prevent or actively encourages also constitute a massive subsidy which the average citizen pays.

There are conservative estimates that the absence of competition in the commanding heights of American industry probably costs the American consumer \$50 to \$60 billion a year. Taking into account other forms of price gouging resulting from the absence of competition,

eminent Americans such as Senator Hart have estimated the cost to the consuming public in the hundreds of billion of dollars.

Ralph Nader's organization has estimated if we had real competition in American industry we could bring prices down by 20 percent or more. Thirty-five percent of the industries in this country, and that includes steel, automobiles, cereals, soap, soup, aluminum, containers, and farm machinery, are dominated by four or fewer firms that have 75 percent or more of production. The result is that they are able artificially to set prices much too high. There are other kinds of results, too, but an excessive price level is one of the principal ones, and it constitutes an enormous subsidy for those corporations and their owners and managers to the detriment of the public.

Now, I think it highly important that this subsidy be eliminated by moving forward to the free enterprise system. Some people say we want to move backward to the free enterprise system. I don't think that is the right way to phrase the problem. I want to move forward to the free enterprise system and I think bringing competition to the market is a better planning mechanism than anything else we can devise. It is better than the administration's hodge-podge policy in regard to wages and prices and other kinds of market restraints. And I believe the advantages of undue market power are an obvious kind of subsidy which we have got to attack.

The top 200 firms in this country today have about 60 percent of manufacturing. In 1946 they had only about 45 percent of manufacturing, so we are getting more and more concentrated. Shared monopolies then which dominate so much of American industry through their control over prices receive through Government inaction a subsidy which I think must be reformed. And related to that is the third form of subsidy that I think requires a fundamental and urgent attack and that is that the regulators are often controlled by the regulated. I believe that that is especially true, for example, in the transportation industry.

I believe we would be far better off to just do away with the Interstate Commerce Commission altogether and allow various modes of transportation to compete fully with each other; and I believe you can look at specific instances of where there is isolated but very important competition in the transportation industry and see enormous savings in transportation costs that result.

Another aspect of that on my mind right now is this whole question of the Federal Communications Commission saying that they simply can't go forward with any kind of basic study of how the A.T. & T. the Bell System throughout the country—sets its rates because the Commission simply hasn't the money. I believe that if it requires it, the Congress ought to appropriate \$1 million or so. It would be well worth the costs if we could bring down the unfair pricing system that Bell uses.

Here is wrapped up the whole business of the regulators being controlled by the regulated. I think that is clearly what is involved here. In fact, we are talking about political power; economic power translates into political power.

Economic bigness, translates almost exactly into political power and in direct proportions. We saw that, for example, lately in the El Paso

Natural Gas case. All over the West, where El Paso Natural Gas serves, it has been able to get every smalltown mayor, every State legislator, every Governor and a good many other public officials to come out for its position, not because the company bribed them—that would be much too cumbersome and costly a way to it. Instead, just as you saw with the Bell System, we are witness to political power. Take the local utility. The manager will be the fellow who will head the cancer drive or head the Community Chest drive or be president of the chamber of commerce. A good portion of his time is spent on public service type efforts and doing good within the community and all of that he is doing at company expense. He is doing that out of rates charged the consumer, out of profits of the company, and his service builds up enormous power, political power, which little by little comes up to the Congress of the United States.

Thus we almost saw—I think we stopped it now—we almost saw the Congress through legislation of retroactive impact do away with about 7 years of court orders, including three Supreme Court orders, requiring El Paso Gas to divest itself of an illegal acquisition in restraint of trade because of the political power that that utility had built up.

So this is another area where we must attack subsidies. We must make those who are regulated truly regulated. We must cut down on their political as well as economic power and reduce their unfair charges.

Lastly, a fourth area, and an area of great interest of mine now, is in the whole field of agribusiness.

When I testified against Earl Butz to be Secretary of Agriculture before the Senate Agricultural Committee, I chose not to go into the usual liberal and conservative or Democratic and Republican issues such as how high the cost of corn is or what percentage of parity we should have and so forth. Instead I chose to get at the real issues, it seems to me, the basic issues in agriculture which have to do with the economic and political power of the small farmer. I was concerned with such basic issues as collective bargaining so that individual farmers would have more muscle in the marketplace.

I was also concerned with the political power of giant agribusiness which translates into unfair subsidies being given to rich farmers and corporate farmers to compete against individual and ordinary farmers who are trying to make their living from the land.

People like Earl Butz have never quite realized what it is I am talking about because they have been so involved with the huge agribusiness firms like Ralston-Purina and others that it always has just seemed the way agriculture has to go.

And you always hear this word "efficiency" when you talk about agribusiness; in other words, it is contended that these big corporations and big firms are more efficient. Well, that is obviously nonsense. If they are so efficient, why do they have to have so much Federal subsidization? It is not a question of efficiency unless you are talking about efficiency in getting Government subsidies, and I grant you they are very efficient at that.

These big corporations and rich farmers are subsidized in several ways. First of all, through the land-grant college system. More and

more of these land-grant college programs are oriented toward doing the research that big corporations want done.

Second, through the labor laws. Thus, in the case of Tenneco or other large corporations with several kinds of business activities, if they go into farming, they are not subject to the same labor laws, unemployment compensation, and regulations governing organization of labor as in the industrial area. Such advantages constitute a subsidy for Tenneco to get into the agriculture business because it will be much easier and cheaper for them to operate insofar as labor is concerned in that field of activity than in other fields.

Third, the tax laws obviously encourage a lot of these big corporations to get into agriculture because they can write off the book losses in agriculture against enormous profits some of them have in other kinds of activity.

And, last, the water laws: We have put enormous amounts of public money into irrigation systems and despite the fact that the laws say that no corporation or farmer ought to be able to get that water—which is provided at public expense—for more than 160 acres, the Federal Government has honored that law in the breach. Some cases against these big corporations, the Federal Government has refused to continue with and, therefore, the corporations continue to boggle up thousands and thousands of irrigated acres in violation of the law, but, more than that, they do this to the detriment of the small farmers because we, the public, pay for that water and the giant corporations get the benefit of it.

Many of the areas I have mentioned the committee has already determined to go into. They are all areas where there are very important subsidies that are unfair and are against the interests of the general public. And many are not obvious to the ordinary citizen.

I appreciate this chance to appear before the committee and, again, I commend you and your staff and the committee members for undertaking this excellent work.

Chairman PROXMIRE. Well, thank you, Senator Harris, for an excellent analysis of the politics of subsidies, something we very much needed in this hearing because that is the heart of much of it.

A statement in your testimony bears emphasis, and I would like to quote it:

The legislative process for considering subsidies is a national disgrace. Programs are casually established and irresponsibly continued with little attention given either to the economic effects for the Nation or the ultimate cost to the taxpayer.

It is a shocking but a correct appraisal and I think you have done an excellent job of documenting that, as did other witnesses, but I did want to emphasize it right at the outset.

Senator Harris, you mention that liberals, not just conservatives, get a good deal of their backing from Wall Street. But you mention some difficulty developed with Wall Street backers in your own campaign because you criticized monopoly power in this country. Could you elaborate on this situation and how frequently it occurs in the relationship between candidate and contributor?

Senator HARRIS. Well, Mr. Chairman, it is obvious that there are a lot of good people with money. A person can be rich and also have a

strong social conscience and virtually every candidate running for President, for the Senate, or for the House has backers of that kind.

Particularly, I think men of this sort have done good work insofar as ending the Vietnam war is concerned. Senator McCarthy had and still has the backing of some rich people who helped him in his campaign particularly because they wanted him to end the war; so I think we must not say that people who are rich necessarily don't have a social conscience because many of them do.

But may I also say it is also easier to continue to have their support if one speaks about issues such as the Vietnam war and there are issues that may not go to their own personal interest.

Today the liberal movement in America stands in the great danger of losing popular support. That is already happening to a large extent because liberals are really not talking about fundamental change.

I don't believe that you can continue our system of Government unless we are going to have a fundamental change. We are going to have more and more concentration of economic power and of political power; therefore, I think we are at a kind of pivotal stage and our political system is not going to be the same as it was unless we really want to get at this inordinate concentration of economic and political power in this country.

It is a lot easier to talk about what General Motors ought to do in the field of safety and so forth than it is to talk about breaking up General Motors into at least five corporations. General Motors is not a human-sized institution; it has more revenue than nine countries. It is something like the Zaibatsu system that existed in Japan prior to World War II and I think we are moving more and more in that direction.

But if you have a fellow whose principal income, say, comes from General Motors stock, he might be a little shaky on that issue. Where he might support you on the oil depletion allowance, he might not be interested in seeing General Motors broken up. Yet such actions are the kind of things that are going to bring some real change.

The same is true about tax loopholes and the one that causes most trouble. I would say, for liberals would be capital gains. There is a great deal of money that comes into the coffers of those who are involved in Wall Street who see the capital gains tax as absolutely necessary to the continuation by capital accumulation of the free enterprise system in this country.

Chairman PROXMIRE. It is a very interesting analysis.

What you are telling us, in order to get elected to office you need money. In order to get elected to the House or Senate you need a lot of money. In order to get elected to the Presidency you need millions, literally millions. It does not come, by and large, from small contributions. You have to get a substantial portion from people who have a whale of a lot of money. As you say, they have a social conscience but when it comes to acting on their particular source of power, which is money, it makes it a lot more difficult. So as long as we have this system of financing our campaigns we are likely to have great difficulty in correcting monopolistic elements that protect a system which is uneconomic, inefficient, discriminatory, very inequitable, it is likely to continue; is that it?

Senator HARRIS. Yes. And I think our laws encourage this system and that is why I think these are things that are really fundamental. In addition to getting at the subsidies frontally, which we ought to do, we should also strike at the problem of inordinate economic power indirectly by beginning to cut down the power of concentrated political and economic units.

One fundamental question is, this whole business of campaign financing. I support a small tax credit for contributions, something like the direct dollar checkoff, which we passed in the Senate, at the Presidential level. In addition to that we ought to give to nominees to the House and Senate and Presidency a minimum amount of television time at reduced costs, say, 20 percent of cost.

All those things would help considerably, as would fundamental reform on how much people can give and how it can be spent.

But in addition to that, we need if we can, to give people a small tax credit for citizens' lobby groups or to use however they please; and, at the same time, to take away the tax advantage that a corporation gets for lobbying as a business expense which it has had since 1962.

Third, I don't think that corporations ought to be able to appeal to the general public on a public issue as a business expense. We have lately seen a really scandalous farce. An organization has been set up to help President Nixon pass his tax and other proposals and, in effect, help his reelection effort and to do so as a business expense of the corporations making the contributions.

Citizens for A New Prosperity, is the name of the organization. It has placed ads and so forth saying: President Nixon has a great tax program in the Congress and it ought to pass; he has got a great economic stabilization program in the Congress and we are getting organized to try to pass that.

This organization wrote to a lot of big corporations saying, "If you want to give up to \$25,000 or so, for the Citizens for A New Prosperity," that being a phrase of President Nixon's, "Then you can do so at business expense."

Now, those of us who were against the President's economic stabilization program and who are against his tax ideas, we don't get any kind of business expense for lobbying against it. It is this kind of disparity that helps to sustain these subsidies politically.

Chairman PROXMIRE. Let me ask you a tougher question: You raised the issue of the fact that the present administration has not seen fit to undertake a program of tax reform. You dramatize the problem with the example of Secretary Connally, who ought to be protecting the taxpayer's dollar, pleading to give U.S. firms DISC because of existing loopholes. This is a good example of the special interest bias of the Nixon administration.

What is equally disturbing is that Congress has allowed this administration to promote its special interests and to disregard the average family in this country. The average family gets very few of the benefits from these tax subsidies; certainly they get nothing from DISC. Yet I don't see the Democratic leadership fighting to eliminate wasteful spending subsidies, reforming the tax system to eliminate inequitable tax subsidies, and bringing other special benefits out into the open.

Don't you think that the Democrats themselves have lost sight of their tradition to challenge the special interests and to thereby represent the ordinary citizen?

Senator HARRIS. Yes, I do, Mr. Chairman. I think this is an issue which transcends the parties involved.

In several unusual capacities I have had a chance to really look at this country pretty carefully—some years ago as a member of the National Advisory Commission on Civil Disorders, lately as cochairman of the Cities of the 1970's and Urban Coalition, and as chairman of the Democratic National Committee, and for a while as candidate for President. I believe, and I say this advisedly, I believe that most people in America do not believe that the political process is going to deliver on their legitimate complaints.

Now, most people in America have been educated to the idea that they are paying more than their fair share of taxes while a lot of rich people are not and everybody in America knows that he is not getting fairness out of what is a scandalous nonsystem of health delivery in this country, for example.

These are a couple of issues. But, by and large, people who know these are legitimate complaints do not feel anything is going to be done about it and this is all tied up with the question of concentrated economic and political power.

I believe politicians—Democratic and Republican alike—are going to have to address themselves to this basic question if we restore confidence in the political process and in our system of government.

Chairman PROXMIRE. My time is up.

Representative BLACKBURN.

Representative BLACKBURN. Thank you, Mr. Chairman.

I am sorry to get here late. I did not have a chance to read the Senator's statement over the weekend.

I do have to state a disagreement here with the chairman who says that the average citizen receives absolutely nothing from DISC which, as I understand, is a tax incentive for corporations to do more overseas trading. I don't think the people who are working for those corporations and whose products are being sold overseas are going to be sad because the sales increase, Senator, and I would suggest we try to confine ourselves to—a little more to reality on occasion.

Senator Harris, I noticed throughout your whole statement you belabor concentration of economic power in corporations and their very strong influence in political campaigns, but I notice nowhere do you touch on the effect of union contributions to political campaigns. There is no question that the unions are the single most powerful influence in this country today.

How do you explain that?

Senator HARRIS. How do I explain they are the single most powerful?

Representative BLACKBURN. Yes.

Senator HARRIS. First of all, I disagree with that. I think the corporations, like General Motors and others, are enormously more powerful; but I would say to the degree that there are abuses that ought to be corrected and to the degree that other than voluntary funds are used in political campaigns this ought to be stopped. If you have instances of that, you ought to see that prosecutions are started.



Representative BLACKBURN. There have been efforts made in the Senate, I know in the House, as well, to provide and to, in fact, just enforce the Corrupt Practices Act.

Senator HARRIS. Why don't we?

Representative BLACKBURN. Which apparently have become sort of a laughing stock so far as realistic enforcement is concerned when it comes to unions.

Senator HARRIS. What is the matter with it then?

Representative BLACKBURN. We have occasionally a prosecution.

Senator HARRIS. What is the matter with the Justice Department? There are a lot of antitrust laws on the books they are not enforcing. We got rid of a fellow, Mr. McLaren, who in recent years had a lot of interest in enforcing the antitrust laws. What is the matter with the Justice Department?

Representative BLACKBURN. You point out the violations and I will take it up with Mr. Mitchell.

Senator HARRIS. I have pointed them out. General Motors is a good one to start with. They are in violation of the antitrust laws.

Representative BLACKBURN. If it is as narrow in scope as your statement indicates here, I don't think it will strike too many responsive chords.

Senator HARRIS. That is the trouble: it doesn't strike a responsive chord, certainly not in this administration, but not generally elsewhere in government. People somehow think there is something good about bigness and yet I think what politicians have not realized, Congressman, is that out in the country people are sick and tired of steel prices going up when volume of sales go down: and they are sick and tired of the automobile prices continuing to go up so that we are almost putting ourselves out of business and all of these Toyotas and Volkswagens and others are coming in—cars that ought to be made in this country—would be made—if we really had a free enterprise system.

I think they are sick and tired of Congressmen and Senators and Presidents and others talking about the free enterprise system and standing in the way of having real competition in this country.

Chairman PROXMIRE. Congressman Reuss.

Representative REUSS. Thank you, Mr. Chairman. I commend you, Senator Harris, for saying some things that needed to be said.

You pointed out the frequent economic effect of large concentrations of economic power, the ability to raise prices, restrict production and so on, and I wondered if you would agree with my observation that there is a political danger, too, in the proliferation of conglomerates' activity, whereby one corporate enterprise gets a foothold in many, many areas of the country, specifically, to the extent that a conglomerate is able to acquire a plant, large or small, in, let us say, 218 congressional districts, it then has something like a majority of the Congress on its side irrespective of whether in the district of a particular Congressman the economic interest which the conglomerate is at the moment pushing happens to be represented.

Would you see, therefore, a political danger in the too great concentration of corporate power, as well as the economic danger that you pointed out?

Senator HARRIS. I certainly do, and I think that that is the basic thing that we have to consider when we consider my assertion that

economic power translates into political power; and probably the principal aspect of that is contained in what you have said, namely that a corporation may locate itself in a lot of different places. We also can give instances of that.

For example, suppose you are opposed, as I was and some of us were, to the bail-out of Lockheed. Then if you have a Lockheed plant in your district, whether it is involved in the particular legislation before the Congress or not, nonetheless it provides a very strong lobbying focal point.

The same is true, for example, in regard to the SST. If you have a little plant in your district that is connected to the parent company, whether it is involved in SST or not, it becomes a very good lobbying focal point. We have seen this on these particular issues and that is especially insidious, it seems to me, in regard to conglomerates because you can get a conglomerate subsidiary in my State to lobby me on something that that subsidiary has nothing to do with because the parent company is involved.

Tenneco has been doing a lot of that. Tenneco is in all sorts of enterprises out in California. Now it has gotten deeply involved in agriculture and it will be using its whole conglomerate apparatus to lobby on agricultural subsidies. This is particularly insidious and I think it is an extra reason why the power of such corporations has to be curtailed.

Representative REUSS. You have mentioned a number of useful remedies to the concentration of power and the subsidy situation which is the subject of your testimony. One, I have to confess, bothers me a little. You suggest a modest tax credit on the order of \$25 to every taxpayer who agrees to contribute this amount to any organization officially registered as a lobbyist and agreeing to certain disclosure requirements.

Well, I have to concede I don't know exactly how to get at what you have in your mind here, but I am a little disturbed at what could well be another new tax loophole. I don't really know that it is sensible to ask the Government, in effect, to contribute \$25 to every lobbying organization that a taxpayer says "We would like to have you contribute to," and I am wondering if we wouldn't just be putting another loophole in the tax system by something like that?

Senator HARRIS. I must confess to you, Congressman Reuss. I have had exactly the same kind of misgivings about that, and I am not sure that is a way to do it. But I know the present system is wrong; there ought to be some better way to do it. It might be sufficient, and certainly I would be awfully happy if we could just take care of the present situation, by not giving a corporation a business tax deduction for advertising on a public issue.

For example, Standard Oil of New Jersey ought not to get a business deduction for telling us in a public ad how wonderfully they are operating insofar as pollution is concerned.

United States Steel ought not to be able to pay for an ad as a business expense which tells us that strip mining, is after all, okay.

Ford Motor Co. ought not to be able to take an ad as a business deduction and tell us that air bags are bad, or Travelers Insurance Co. shouldn't be able, as a business deduction, to run ads against no-fault insurance.

So perhaps if we just stopped that abuse and if we took away the business deduction for lobbying for corporations, that would be the best way to go after the problem. I do have some misgivings on the tax proposed for public interest lobbies and I appreciate your bringing this matter up.

Representative REUSS. Thank you very much.

Chairman PROXMIRE. Senator Harris, you said that :

Subsidies are to modern politics what patronage was to the politics of the 19th century. Subsidies, in other words, are the lifeblood, tainted to be sure, of our electoral system.

I am very happy for you to call this to our attention because, as you say, many people in the Congress and press, certainly in the country, feel that patronage is the problem, the driving and corrupting force.

You went on to explain that this means the moneyed interests in this country support candidates not so much for the special favors they will do but just to get them to leave the existing system of special benefits alone. Isn't this why we get so little fundamental reform in our system ?

Senator HARRIS. Yes, I think so. Our system is remarkably stable. What I mean is it is stable like an ecological system so that almost any attempt to reform it is rebuffed. The system resists change enormously and one reason why it resists change is the people who have the subsidies have the cash to help keep the political system favorable to their subsidies. As I said, maybe we can attack these subsidies indirectly by breaking the chain of connected power insofar as the tax laws and campaign financing and other laws are concerned, although, obviously, we have got to take on the subsidies frontally, too.

Chairman PROXMIRE. You make a fascinating suggestion here that I think would be a terrific reform and that we have the power to do and that is that markup sessions in congressional committees be made public. This is the most important action I think Congress takes. It is the committee that really determines the nature of legislation, by and large. Its action can be amended on the floor but usually the committee determines the basic cast and often the last word, especially in the House.

I have often thought of this and I thought if I ever did become chairman of a standing committee this would be one of the first things I would fight for in the committee. Of course, the chairman can't do this by himself unless he can get the committee to go along with it, but he often has influence on the committees, especially if he is chairman.

You called my attention to something I didn't know. You say the House Education and Labor Committee has already adopted this practice ?

Senator HARRIS. That is my understanding.

Chairman PROXMIRE. Do they have this for every markup session or only use this on occasion ?

Senator HARRIS. My understanding is that they are doing it quite regularly.

Chairman PROXMIRE. It is a great reform.

Senator HARRIS. When I first came here I was surprised we had closed markup sessions. I served 8 years on the Oklahoma State Senate and we considered votes in the committee like in the Senate, so the press was there and votes were called.

Chairman PROXMIRE. In Wisconsin we are very proud of what we have done. But we had closed markup when I was in the assembly in 1951.

Senator HARRIS. I heard and I was swayed by the argument here, "Well, this allows us to move our business much more rapidly without grandstanding and so forth," but I think it also means that there is less public control of what is happening.

Chairman PROXMIRE. I think so, too. I think this would probably be one of the most fundamental reforms we could adopt in this area; focus attention sharply and clearly on Senators voting against the public interest or Congressmen voting against the public interest, and I think a most effective way.

Any further questions?

Representative BLACKBURN. No, Mr. Chairman. I want to state for my own part, though, I have had some experience with open markup sessions and it is the most dismal performance that I have ever been attending on. Every one of us in this business has a heavy streak of ham in him; that is one of the qualifications, I suppose, for running. The result is everybody on the committee has to make a speech. On our committee, of course, any votes we take, any vote is a matter of public record, any member of the public can find out.

Chairman PROXMIRE. House Banking?

Representative BLACKBURN. That's right; House Banking. Any member of the public can find out what the motion was or what the vote was. In my own experience, everybody had to get in the act. It got downright mean for the committee. Some of the committee members were pounding on the desk shouting at the chairman; lobbyists were passing notes up to the members suggesting which votes they favored and votes they did not favor. Altogether, I thought the dignity of the Congress suffered. Maybe it was the nature of my committee, but if that is true of all other committees, I don't think it is in the best interests of the country.

Senator HARRIS. I might say I think some of the people use that as an argument against the democratic process.

Chairman PROXMIRE. It is worse except for all the others.

Representatives REUSS. Mr. Chairman, as long as we are having a psychoanalysis of the House Banking and Currency Committee—

Representative BLACKBURN. We don't have time for that now.

Representative REUSS. I might give my testimony which is that it is precisely the dismal situation which Congressman Blackburn has just pointed out, with lobbyists passing notes and so on which, in my judgment, indicates that sessions ought to be open. If notes are being passed let the public find out who is passing and who is receiving them.

Representative BLACKBURN. They don't pass them in closed sessions. There are no notes passed in closed sessions; there are no lobbyists in the room and you avoid the possibility.

Representative REUSS. It is a question of taste.

Chairman PROXMIRE. Senator Harris, when you just say in conclusion, you make several recommendations:

First, the public should know who are the direct beneficiaries of Federal subsidy payments; second, that markup sessions in congressional committees must be public; third, that the objective of a subsidy ought to be fundamental economic change so that the subsidy may

eventually be phased out; fourth, that we have a congressional overseer of Federal subsidy and special-benefit programs; and, fifth, that we ought to end the tax subsidy to business lobbies and then provide a tax subsidy to a diverse range of public-interest groups. I think these are five recommendations and I join you in supporting them.

I want to thank you very much for another fine service that you have provided during this morning. Thank you very much.

Senator HARRIS. Thank you, Mr. Chairman.

Chairman PROXMIRE. Our next witness is a distinguished gentleman who comes before us now as a distinguished professor of economics. He was formerly a member of the Nixon administration, one of the top ranking people in the Treasury Department.

Mr. Weidenbaum has given this subcommittee valuable testimony on numerous occasions. He was a professor and chairman of the department of economics at Washington University for several years. Most recently he served as Assistant Secretary of the Treasury for Economic Policy, where he did an outstanding job.

Last year Mr. Weidenbaum returned to Washington University and is now a distinguished university professor.

It is a pleasure to have you with us again, Mr. Weidenbaum.

**STATEMENT OF MURRAY L. WEIDENBAUM, MALLINCKRODT DISTINGUISHED UNIVERSITY PROFESSOR, WASHINGTON UNIVERSITY, ST. LOUIS, MO.**

Mr. WEIDENBAUM. Thank you, Mr. Chairman, and members of the committee. Truly it is a real pleasure to be invited to return to the Joint Economic Committee. I hope it is possible to be even more objective than I was when I previously testified before your committee.

Chairman PROXMIRE. You have a very interesting prepared statement which, together with the tables, will be printed in full in the record.

Mr. WEIDENBAUM. Fine.

I would like to summarize my prepared statement, if I may.

My testimony this morning deals with a most pernicious type of subsidy, the hidden subsidies which the public is not aware of and which Congress may not even have intended.

I would like to begin by citing a typical case in point, the situation where the Treasury pays a 7.5-percent interest rate on borrowing and then turns around and makes loans to a particular group at, say, 2 percent. Clearly, in that case, the Federal taxpayer is subsidizing that particular group to the tune of 5.5 percent. Moreover, the subsidy may have been unintentional in the first place. I am talking, of course, about one instance among many, the rural electrification program, which has a 2-percent interest rate. When the Congress passed the original legislation, the Treasury was paying about 2 percent on the national debt so no subsidy was initially intended. But that certainly is one subsidy among many.

Substantial subsidies in the form of these low interest rates are provided through Federal credit programs to many sectors of the American economy—housing, agriculture, health, education, State and local government as well as—but certainly not exclusively to—business.

Most Federal loan programs contain some element of subsidy and, as I will show, the magnitude of these hidden subsidies is extremely substantial.

In 1970 alone the use of the governmental credit power resulted in hidden but very real subsidies in excess of \$5 billion.

An important limitation of this analysis must be acknowledged. The degree of subsidy which I measure depends in good part on the discount rate used as the basis for comparison. In the calculations underlying my tables in my prepared statement I use an interest rate of 7.5 percent simply because that is the interest rate which the Treasury was paying in 1970, which was the year my data cover on credit programs, for 5 to 7 year issues. Typically, that is the kind of money the Treasury was borrowing in order to turn around and loan out in the form of a credit program.

I could have used—and in my prepared statement I do use—a 9.5-percent rate alternative because that approximates the yield on federally guaranteed loans. Of course, that gets to an even higher subsidy figure.

There are four major kinds of Federal subsidy programs:

The first are direct loans by Government departments such as the 2.5-percent urban renewal loans. In many cases the Government also absorbs the administrative costs and the losses arising from loan defaults, thus increasing the amount of subsidy.

Even though it is not normally considered a credit program, the progress payments made by the Department of Defense do represent interest-free working capital to Government contractors and I will discuss that.

The second kind of subsidies are loans guaranteed and insured by Federal departments and agencies. These account for the really large rapid expansion in Federal credit programs in recent years, mainly because these are excluded from the budget.

The third kind of subsidy in the credit programs are straight interest subsidies; that is, where the Federal Government pays a portion of the interest rate on private loans.

The fourth kind of subsidies are loans made by federally sponsored agencies, such as Fanny Mae and the farm credit agencies. These ostensibly privately owned agencies have tax advantages and are able to borrow money in the markets at low interest rates because of the implicit governmental backing of their activities; hence their activities, to a minor extent, raise the cost of Treasury borrowing paid for by the taxpayers.

In recent years the great bulk of federally extended credit has been in the form of guarantees of private credit via Government sponsored intermediaries. Such guarantees in fiscal year 1972 total \$24 billion of a total increase of \$33 billion of Federal credit in that year.

On a cumulative basis, that is looking at the total amount of Federal credit outstanding, federally guaranteed and insured loans cover \$167 billion or two-thirds of the total of \$252 billion of Federal credit which the Government estimates will be outstanding as of the end of this fiscal year.

It is not hard to see the reasons for the growing popularity of these programs. Most of them are not included in the budget. Hence, they

seem to be a relatively painless way of achieving a national objective.

Moreover, the segments of the society which obtain the loans, of course, do benefit, but at the expense of the rest of us.

The effect of a subsidy simply is to change the allocation of resources, with some potential buyers being crowded out. A credit subsidy increases the market power of the subsidized borrower. In essence, at the heart of a subsidy is a political decision to favor some at the expense of others.

The tables in my prepared statement do not include a large amount of financing that the Federal Government provides to defense contractors in the form of interest-free payments during the production period, so-called progress payments. Technically, these are not loans and, frankly, the term "subsidy" may not be an appropriate description. But these are large financing activities and some attention, I think, is worthy.

As of June 30, 1970, there were approximately \$9.8 billion of progress payments outstanding on defense contracts. In fact, military procurement regulations provide specific incentives against the use of private working capital. Thus progress payments equal to as much as 80 percent of the costs incurred in working on defense contracts are generally provided on a current basis and without any interest or service charge. This is far more generous than these same companies receive on commercial aircraft or other large private orders.

However, should these companies—and this is a major however—should these companies decide to rely on private sources for working capital, they cannot charge those interest payments to the Government contract. This is what biases their decision in favor of taking these large amounts of government working capital payments.

Presumably, of course, the present arrangement results in a smaller total cost to the Government, particularly on cost-reimbursable contracts because of the lower interest rates paid by the Treasury on the funds that it borrows and, in turn, turns over to the contractor; hence, I can't say for sure that progress payments necessarily generate subsidies. What is clear is that this governmentally supplied interest-free working capital does increase the extent to which public rather than private capital finances the operations of Government contractors.

To summarize, table 1 in my prepared statement provides estimates of the amount of subsidy in each of the various Federal credit programs. As you can see, the operation of these programs for fiscal 1970 will result in ultimate interest subsidies, that is, over the life of the loans extended in 1970 of \$5.1 billion. This is based on using that 7.5-percent discount rate.

The 9.5-percent rate would yield a subsidy estimate of \$6.5 billion.

Perhaps more meaningful than these absolute figures is the ratio of subsidies to the total amount of the loans extended or guaranteed. In several cases the subsidy is equal to more than half of the amount of the loan. For example, in the REA loans the subsidy is equivalent to a cash grant of 50 percent of the loan amount, with the remaining 50 percent extended at a 7.5-percent rate. In the case of the soft foreign aid loans, the subsidy is equal to a cash grant of 57 percent of the face of the loan.

I suggest, finally, several ways of dealing with the problem of subsidies in Government credit programs.

First of all, the Congress should require that all proposals to create new Federal credit programs or to broaden existing ones must be accompanied by an estimate of the interest rate to be charged to the program, and also the interest rate which would be necessary to cover the Government's costs. This would help to reduce the hidden nature of these credit subsidies.

Second, the Congress should establish controls over the total volume of Federal credit. At present, many of these Federal credit programs have virtually a blank check on the Nation's credit resources. They should no longer be treated as a free good. There are several specific ways of achieving more effective control:

One is to impose a ceiling on the total borrowing of Federal and federally sponsored credit agencies, including those in and out of the budget. A comprehensive Federal financing bank would help to achieve this objective.

Another way is to enact a ceiling on the overall volume of credit created under the Federal loan guarantees.

A third step—and, frankly, I offer this in lieu of a separate committee or study or commission on subsidies—is to require that these credit programs, as well as other subsidy programs, be reviewed and coordinated along with all other Federal programs in the preparation of the Government's annual budget and economic plans. Don't shunt them off into a corner with a special committee; put them right in the comprehensive review and preparation of the Government's fiscal and economic plans, because at the present time numerous Federal Government credit programs escape regular review either by the executive or the legislative branch.

However, Mr. Chairman, and members of the committee, please do not misunderstand me. Mine is not a blanket condemnation of all subsidies but rather it is a plea for making them visible so we can see them in the light of day, so that we can see how much they are really costing us and then determine whether they are worth it.

We should not overlook the fact that decisions to give certain groups of borrowers more or better access to credit may permit reductions in direct Government spending programs in the same program area.

To conclude, in all of this we need to keep two points in mind:

First, Federal credit programs are more than mere financing instruments. Changes in the nature and volume of these programs also become changes in public sector priorities and in the allocation of national resources.

Second, expanding the use of these credit programs does not increase the amount of savings in the economy available to finance investment; hence, the payment to Paul may unwittingly be robbing Peter.

Thank you.

Chairman PROXMIER. Mr. Weidenbaum, you have certainly taken a very important step in appearing here this morning and making these recommendations and beginning the process of a far more rational approach to credit subsidies. They are a mystery to most of us. They have been badly overlooked. They have an effect which very few people, even those who should have responsibility for it, do not pay much attention to, especially once they get it written into law then that is it; they go on and on.



I would like to ask that your full statement be printed in the record because you did skip over part of it.

Mr. WEIDENBAUM. Thank you.

(The prepared statement of Mr. Weidenbaum follows:)

PREPARED STATEMENT OF MURRAY L. WEIDENBAUM

HIDDEN SUBSIDIES IN GOVERNMENT PROGRAMS

The Federal Government provides, to selected groups of the population, many types of goods and services below their normal market cost. The difference between the market price and the lower government price is the amount of subsidy being received by the particular group. My testimony deals with a most pernicious type of subsidy, the hidden subsidy, which the public may not be aware of and which often Congress may not have intended.

A case in point is the situation where the Treasury pays a 7½ percent interest rate to borrow money and then turns around and makes 2 percent loans to one particular group. Clearly, the Federal taxpayer is subsidizing that particular group. Moreover, the subsidy may have been unintentional in the first place. When the Congress passed the original legislation for the program, the Treasury was paying about 2 percent interest on the national debt.

Substantial subsidies, in the form of low interest rates, are now provided through Federal credit programs to a great many sectors of the American economy—housing, agriculture, transportation, health, education, state and local governments, business—as well as to foreigners. Most Federal loan programs contain some element of subsidy. As I will show, the magnitude of these hidden subsidies is extremely substantial. According to the estimates that I will present, in 1970 alone, the use of governmental credit power resulted in hidden but very real subsidies in excess of \$5 billion.

THE MEASUREMENT OF CREDIT SUBSIDIES

My use of the term subsidy here refers to the cash cost to the Government of Federal credit programs including (a) direct interest subsidy payments, (b) implicit interest subsidies arising from the difference between the rates at which the Government is currently lending and the rates at which it is currently borrowing, (c) the cost of administering the loan programs, and (d) the cost from any defaults on such loans, to the extent that these costs are not covered by fees or other changes imposed on private borrowers or lenders.

An important limitation of the analysis needs to be acknowledged. The degree of subsidy which is identified depends in good measure on the discount rate which is used as the basis for comparison. I am using an interest rate of 7½ percent in the calculations that I will be presenting.

This rate is chosen because it is close to the average Treasury borrowing rate for 5 to 7 year issues in 1970, which is the year covered by my data on Federal credit programs. (If a higher rate, such as 9½ percent which approximates the typical gross yield on Federally-guaranteed loans in that year, is used of course the resultant subsidy estimates would be higher).

The value of the interest subsidy varies directly with (1) the difference between the interest rate paid by the borrower and the market rate of interest, (2) the maturity of the loan, and (3) the extent to which interest is forgiven or amortization delayed during the life of the loan.

BACKGROUND

I would like to offer some necessary background information and then get to the subsidy figures as well as some recommendations. Federal credit is provided in four major forms:

1. *Direct loans by Federal departments and agencies.*—These, such as the two percent loans made by the Rural Electrification Administration, generally involve significant subsidies because of low lending rates. In many cases, the Government also absorbs the administrative expenses and losses arising from loan defaults, thus further increasing the amount of the subsidy. The volume of direct Federal loans outstanding has virtually stabilized in recent years at about the \$50 billion level.

Although not formally considered a Federal credit program, the relatively generous progress payments made by the Department of Defense do represent interest-free provision of working capital to government contractors on a very large scale.

2. *Loans guaranteed and insured by Federal departments and agencies.*—These account for the greatest share of the current expansion in Federal credit subsidies, largely because the loans are excluded from the budget. Also, there has been a substantial increase in the Federal payments of part of the interest on insured loans for such programs as low income housing. The volume of guaranteed and insured loans outstanding is estimated to increase from \$125 billion on June 30, 1970 to \$167 billion on June 30, 1972.

3. *Interest subsidy payments on loans made by private lenders.*—As I have just noted, these subsidy payments are made in connection with some guaranteed loans. Federal interest subsidy payments are also provided for certain loans which are not guaranteed, such as college housing loans.

4. *Loans by Federally-sponsored agencies, such as the Federal National Mortgage Association, the Federal Home Loan Banks, and the farm credit agencies.*—These involve relatively little direct subsidy. However, these ostensibly privately-owned agencies have various tax advantages and are able to borrow funds in the market at low interest rates because of the implicit Government backing of their activities (to some minor extent, thus perhaps also raising the cost of Treasury borrowing). Loans made by sponsored agencies have increased sharply over the past decade, largely because of the secondary market support provided for housing. The total of these loans outstanding is estimated at \$53 billion at the end of fiscal year 1972.

In recent years, the great bulk of Federally-extended or Federally-assisted credit has been in the form of Federal guarantees of credit provided by private sources via these governmentally-sponsored intermediaries. Such guarantees in the fiscal year 1972 are estimated to represent \$24 billion of the total increase of \$33 billion of Federal credit for the year. On a cumulative basis, Federally-guaranteed and insured loans are estimated at \$167 billion or two-thirds of the total of \$252 billion of Federal credit outstanding on June 30, 1972.

It is not hard to see the reasons for the growing popularity of these programs extending governmental credit. Most of them are not included in the Federal Budget. Hence, they seem to be a relatively painless way of achieving some national objective. Moreover, the segments of the society to which the specific programs are directed receive a benefit at the expense of the rest of us.

The effect of the subsidy is to change the allocation of resources, with some potential buyers being "crowded out." Thus a credit subsidy increases the market power of the subsidized borrower. At the heart of a subsidy is a political decision to favor some of the expense of others.

#### A NOTE ON PROGRESS PAYMENTS

My tables do not include the large amount of financing that the Federal Government provides to its contractors in the form of interest-free payments during the production period (so-called "progress payments"). Technically, these payments are not in the form of loans and the term "subsidy" may not be an appropriate adjective for them. Nevertheless, these financing activities are large enough to be worthy of some attention.

As of June 30, 1970 approximately \$9.8 billion of progress payments were outstanding on existing Department of Defense contracts. Such part payments made by the government, in the case of the large government-oriented corporations, often represent a major portion of their total working capital. Military procurement regulations provide specific incentives against the use of private working capital. Thus, progress payments equal to as much as 80 percent of the costs incurred in working on defense contracts are generally provided on a fairly current basis and without any interest or related service charge. This is far more generous than these companies receive on commercial aircraft or other large private orders.

However, should these companies decide to rely on private sources for working capital, their interest payments may not be charged to the government contract, and hence must come out of their profits. Presumably, this arrangement results in a smaller total cost for the government, particularly on cost-reimbursable or other cost-based contracts, because of the lower interest rates paid by the Treasury on the funds that it borrows.

Hence, it is not clear that progress payments necessarily generate subsidies. In any event, this governmentally-supplied, interest-free working capital increases the extent to which public rather than private capital finances the operations of government contractors.

## SUMMARY AND EVALUATION

Table 1 provides subsidy estimates for the various Federal credit programs. As can be seen, the operation of these programs in the fiscal year 1970 will result in ultimate interest subsidies to the direct beneficiaries of these programs of \$5.1 billion, using a 7.5 percent discount rate (at a 9½ percent rate, the subsidies would total \$6.5 billion). Of these subsidies, about one billion dollars were received in the first full year, with the remaining benefits to occur in future years, depending on the length of the loan or loan guarantee.

TABLE 1.—INTEREST SUBSIDIES IN FEDERAL CREDIT PROGRAMS, FISCAL YEAR 1970

[In millions of dollars]

Agency and program	Gross loan outlays	Interest rate (percent)	Estimated subsidy	
			First year	Capitalized value
DIRECT LOANS				
Funds appropriated to the President:				
Security assistance.....	136	6	1	9
Development assistance.....	906	12	50	517
Agriculture:				
Commodity Credit Corporation:				
Price support.....	2,338	3½	94	87
Public Law 480.....	494	2½	19	226
Export credit sales.....	209	6½	1	3
Storage facilities.....	50	6	(2)	2
Rural Electrification Administration:				
Rural electric.....	362	2	15	179
Rural telephone.....	135	2	6	67
Farmers Home Administration:				
Soil, water and watershed.....	65	5	1	17
Farm operating.....	280	6½	2	8
Emergency credit.....	90	3	3	6
Rural housing.....	143	6¼	1	18
District of Columbia:				
Capital outlay loans.....	89	6¼	1	11
Repayable advances.....	40	0	2	1
Commerce:				
Development facilities.....	15	5¾	(2)	3
Industrial development.....	26	6¼	(2)	2
Health, Education, and Welfare:				
Capital for student loans.....	217	3 0-7	16	76
Higher education facilities.....	102	3	4	46
Housing and Urban Development:				
Urban renewal.....	595	2¼	16	16
Low-rent public housing.....	720	0¾	36	34
College housing.....	184	3-0	7	84
FHA fund.....	135	5¼	2	28
Housing for elderly.....	106	3	4	53
Public facility loans.....	44	5½	1	10
Rehabilitation fund.....	39	3	1	12
Justice: Law enforcement education.....	18	1 0-3	1	4
Transportation: Highway advances.....	3	0	(2)	1
General Services Administration: Surplus property sales.....	44	7	(2)	1
Veterans' Administration:				
Loan guarantee revolving fund.....	198	8½	-2	-18
Direct loan fund.....	115	8½	-1	-11
Insurance policy loans.....	195	4	4	30
Export-Import Bank:				
1,569.....	1,569	6.3	12	65
Equipment and service loans.....	1,095	5.9	11	63
Commodity loans.....	67	6	1	1
Discount loans.....	146	7	1	1
Other.....	260	(4)	(4)	(4)
Small Business Administration:				
Business and investment fund.....	279	6.2	2	18
Displaced business loans.....	31	5½	1	5
Economic opportunity loans.....	35	6½	(2)	1
Small business investment company loans.....	56	7¼	(2)	1
Small business loans under sec. 7(a).....	84	5½	1	6
Development company loans.....	47	5½	1	6
Other.....	25	(4)	(4)	(4)
Disaster loan fund.....	91	3	3	19
<b>Total, subsidized direct loans.....</b>	<b>10,032</b>		<b>301</b>	<b>1,624</b>

TABLE 1.--INTEREST SUBSIDIES IN FEDERAL CREDIT PROGRAMS, FISCAL YEAR 1970--Continued

[In millions of dollars]

Agency and program	Gross loan outlays	Interest rate (percent)	Estimated subsidy	
			First year	Capitalized value
<b>GUARANTEED AND INSURED LOANS</b>				
Agriculture:				
Farmers Home Administration:				
Rural housing insurance.....	987	6.3	10	118
Agricultural credit insurance.....	703	5	15	187
Farm ownership.....	356	5	5	68
Water and sewer.....	82	5	2	22
Other.....	265	(4)	(4)	(4)
Health, Education, and Welfare:				
Student loan insurance.....	840	3 0-7	63	179
Higher education facilities:				
Public institutions.....	80	3	3	32
Private institutions.....	40	3	1	14
Housing and Urban Development:				
Urban renewal.....	569	1.6	22	21
Low-rent public housing.....	1,517	0	114	1,039
Interim financing.....	3,529	0	176	168
College housing:				
Public institutions.....	165	3	6	68
Private institutions.....	37	3	1	13
Mortgage insurance (subsidized):				
Below market rates.....	296	3	11	135
Other.....	2,932	2	122	1,493
Export-Import Bank: Portfolio sales.....	406	5.8	5	17
Total, major subsidized guaranteed and insured loans.....	12,101		551	3,484
Grant total, Federal credit programs.....	22,133		852	5,108

<sup>1</sup> Interest rate shown is for 1st 10 years only. Rate is 3 percent for last 30 years.

<sup>2</sup> Less than \$500,000.

<sup>3</sup> Zero interest rate applies only while student is in school plus 9 months (average period 3 years); thereafter rate is 3 percent on direct loans, 7 percent for insured loans.

<sup>4</sup> Not available.

Housing programs produced the bulk of the subsidies. Other substantial amounts of subsidies occurred in foreign aid, farm price supports, student loan assistance, and export promotion.

Perhaps more meaningful than these absolute figures on the dollar values of subsidy received is the ratio of subsidy to the total amount of the loan extended or guaranteed. In several Federal credit programs, the subsidy is equal to more than one-half of the total amount of the loan.

For example, in the case of the Rural Electrification Administration program of 2 percent loans, the subsidy could be provided alternatively in the form of an initial cash grant of 50 percent of the loan amount, with the remaining 50 percent extended at a 7½ percent interest rate.

Using a 7½ percent discount rate, the following major Federal programs are shown to result in interest subsidies equal to one-half or more of the principal of the loan (see Table 2 for details):

Foreign economic aid (development assistance).

Rural electrification.

Housing for the elderly.

Low-rent public housing.

Subsidized housing mortgage insurance.

If a 9½ percent discount rate had been used, the list would be lengthened to include the following:

Commodity Credit Corporation (P.L. 480);

Higher education facilities;

College housing.

TABLE 2.—*Ratio of interest subsidy to total amount of loans, fiscal year 1970*

<i>Agency and program</i>	<i>Ratio of sub- sidy to loan (percent)</i>
Direct loans (outlays)—	
Funds Appropriated to the President:	
Security assistance.....	7
Development assistance.....	57
Agriculture:	
CCC: Price support.....	4
CCC: Public Law 480.....	46
Farmers Home Administration.....	8
Rural Electrification Administration.....	50
Health, Education, and Welfare:	
Capital for student loans.....	35
Higher education facilities.....	45
Housing and Urban Development:	
Urban renewal.....	3
Low-rent public housing.....	5
College housing.....	46
FHA fund.....	21
Housing for elderly.....	50
VA: Insurance policy loans.....	15
Export-Import Bank.....	4
Small Business Administration:	
Business and investment fund.....	6
Disaster loan fund.....	21
Average, major subsidized direct loans.....	18
Guaranteed and insured loans (commitments):	
Agriculture:	
Rural housing insurance.....	12
Agricultural credit insurance.....	27
Health, Education, and Welfare:	
Student loan insurance.....	21
Higher education facilities.....	38
Housing and Urban Development:	
Urban renewal.....	4
Low-rent public housing.....	68
Interim financing.....	5
College housing.....	40
Mortgage insurance (subsidized).....	50
Export-Import Bank: Portfolio sales.....	4
Average, major subsidized, guaranteed and insured loans.....	29

## RECOMMENDATIONS

I suggest several ways of dealing with the entire problem of subsidies in Federal credit programs.

1. *Require that all proposals to create new Federal credit programs or to broaden existing ones be accompanied by an appraisal of the relation between the interest rate charged in the program, the rate which would be charged by competitive and efficient private lenders, and the rate necessary to cover the Government's costs.*

2. *Establish controls over the total volume of Federally-assisted credit.* Even though no immediate impact on the Federal Budget may be visible in most cases, the influence on the allocation of resources—on the composition of income and employment—may be very considerable. At present, many of these Federal credit programs tend to have virtually a blank check on the nation's credit resources. They should no longer be treated as a "free good".

2A. *Impose a ceiling on the total borrowing of Federal and Federally-sponsored credit agencies, both those "in" and those "out" of the budget.* A Federal Financing Bank would help achieve this objective.

2B. *Enact a ceiling on the overall volume of debt created under Federal loan guarantees.*

2C. Establish procedures to permit review of commitments become actual loans.

3. *Require these credit programs to be reviewed and coordinated along with other Federal programs in the preparation of the Government's annual budget and economic plans.* At the present time, numerous Federal credit programs—guaranteed and insured loans, and loans by Federally-sponsored enterprises—escape regular review by either the executive or the legislative branch. We need to satisfy ourselves that these programs are consistent with economic growth and stability (the question of their overall volume) as well as with budget priorities (the question of the subsidy element). We should not overlook the fact that decisions to give certain groups of borrowers more or better access to credit markets that otherwise would be the case may permit reductions in direct government spending programs in the same functional area.

In all of this we need to keep two points in mind: (1) Federal credit programs are more than mere financing instruments; changes in the nature and volume of these programs also become changes in public sector priorities and in the allocation of national resources, and (2) expanding the use of these credit instruments does not increase the amount of savings in the economy available to finance investment; hence, the payment to Paul may unwittingly be robbing Peter.

Chairman PROXMIRE. In your prepared statement you say:

Thus these companies—

That is, the ones who get progress payments—

should they decide to rely on private sources for working capital, their interest payments may not be charged to the government contract and hence must come out of their profits.

So there is a bias, as you point out; they are not going into the private market where you have competitive forces which could be competitive and wholesome. Instead, they get these interest-free loans, instead these progress payments, and they are not on an equal basis because they cannot charge the interest cost they would pay in the private market.

Why can't they? What is the rationale behind that decision?

Mr. WEIDENBAUM. Well, there is a rationale and I allude to it indirectly in my prepared statement. The fact that at the present time—because the Treasury can borrow at a lower rate than a private company—it is technically cheaper for the Treasury to borrow at this low rate and turn around and advance the money to the defense contractor than have the defense contractor go out in the market, raise the money paying a slightly higher rate and then charge that interest rate to the Government contract.

As you know, Mr. Chairman, I have not hesitated to criticize practices of defense contractors. But in this case, interest on working capital, I think, is just a standard, legitimate business expense and it should be allowed.

Chairman PROXMIRE. I would think so, too, and I think you would have a better situation, greater option. Why not?

Mr. WEIDENBAUM. Also, it would free up some major part of that \$9.8 billion of Federal money for other uses.

Chairman PROXMIRE. Exactly; that is the point.

In your prepared statement you have a whole series of very interesting recommendations. How difficult would it be, and you were a Treasury official until very recently—how difficult would it be to comply with that No. 1 recommendation, "Require that all proposals to create new Federal credit programs or to broaden existing ones be accompanied by an appraisal of the relation between the interest rate charged

in the program, the rate which would be charged by competitive and efficient private lenders, and the rate necessary to cover the Government's costs?"?

Mr. WEIDENBAUM. I think that is a very manageable recommendation. The main thing it will take is the requirement that it be done.

Chairman PROXMIRE. So that all you would need are very few people to do this. Where would you suggest they be located in the executive branch or the Bureau of the Budget?

Mr. WEIDENBAUM. I can think of the need for this sort of work in more than one place. In other words, if, to cite a hypothetical example, the Department of Health, Education, and Welfare, drafts legislation for consideration by the Education and Labor Committees on student loan programs or student loan guarantee programs, for example, they would be required, if this sort of provision were enacted, to prepare these estimates in drafting the legislation.

Chairman PROXMIRE. Wouldn't you get better estimates if they didn't come from an agency which had an incentive for keeping the estimate down? Wouldn't it be better from a central—

Mr. WEIDENBAUM. I assume that the Office of Management and Budget would issue directives or circulars so that estimates of the private cost of capital would not vary according to who is making the estimate.

Chairman PROXMIRE. Very good.

Mr. WEIDENBAUM. Also, I should point out the Department of the Treasury has developed a particular expertise in this area. I don't want to ignore my former staff.

Chairman PROXMIRE. Then you suggest in the proposal No. 2, to establish controls over the total volume of federally assisted credit, and I think this is so very important.

Recently we exempted the Export-Import Bank which, I thought, was a tragic mistake, from the budget.

Mr. Weidenbaum, what this means, if you exempt them, that the enormous amounts they borrow tend to deplete the capital market and under circumstances of credit stringency, it may mean that there will be less money for housing, for State and local government, for schools, for hospitals, and for other things. At least we ought to know about that; we ought to have a report on it so we have a clear notion of how our credit priorities are going. It would seem to me, that by establishing controls of this kind this would be one of the real benefits that you would begin to get.

Mr. WEIDENBAUM. Mr. Chairman, I think it is stronger than that. First of all, I am not thinking of any justification for exempting the Export-Import Bank from budgetary controls. There isn't even the subterfuge that it is ostensibly privately owned as in the case of Fanny Mae or the land banks. It is a Government-owned operation and ought to be included in the unified budget.

However, the ceiling on the credit I have in mind wouldn't be informational.

Chairman PROXMIRE. They would not be advisory?

Mr. WEIDENBAUM. Yes, sir.

Chairman PROXMIRE. How would you be able to fix that? I suppose you would have to fix that somehow working with the Federal Reserve Board, wouldn't you?

Mr. WEIDENBAUM. Well, of course, in determining the amount of credit to be expended in any period, here is where monetary and fiscal policy clearly mesh. In fact, these Government credit programs, in a sense, fall in between the two stools of monetary and fiscal policy. I think legislation on a Federal financing bank which has recently been submitted to the Congress for its consideration would be the initial way of carrying out this kind of recommendation.

Chairman PROXMIRE. So an important element of a monetary policy calculated to prevent inflation would be having control and having a ceiling over your Federal loan programs? Otherwise, what you do is you have an area that becomes insensitive to monetary policy no matter what the Federal Reserve does and we get an enormous borrowing in the Government sector and meanwhile private housing, State and local, suffer. They carry the brunt, in effect?

Mr. WEIDENBAUM. Yes, Mr. Chairman. They really are mechanisms at the present for avoiding making hard decisions like in the case of the Export-Import Bank. I certainly appreciate the need to encourage greater exports; however, given the amount of funds, the amount of resources available in the economy and of savings for investment available in the economy at the present time, the correct decision, if it is the will of the Congress to expand the activity of the Export-Import Bank or any other export promotion of that nature, is not to move it out of the budget but within the budget to give it a greater share at the expense of some lower priority program. I am concerned that rather than making such decisions—most of the decisions I hear about concerning priorities are in terms of giving more money to some high priority area. But that is only half the job, the easier half, I may say. The harder, the really essential, step to conclude a shift to a new set of priorities is to curtail what has become the lower priorities.

Chairman PROXMIRE. Then you say require these credit programs to be reviewed and coordinated along with other Federal programs, and you stressed that this should be part of the budgetary process and not treated by a special committee.

One difficulty here is I am afraid it would be lost. The budget is so colossal now; it is so enormously detailed that unless you have some particular responsibility that is set up to go into this, some subcommittee or some committee of the Congress, for example, or some way of highlighting it, it seems to me, that this isn't going to be—you are not going to get the kind of attention you should get on it.

I understand your notion it should not be set out by itself and forgotten, but separating it might be a better way to call attention to it.

Mr. WEIDENBAUM. Well, I made this recommendation, frankly, after thinking about my own experiences in what then was the Bureau of the Budget. Activities which were part of the central estimating budget review process really were the ones that received the attention, the concern of not only the budget examiners but all through the top echelon of the Budget Office and the White House. Those which were peripheral items, which were not part of the central budgetary review process, were in good measure cosmetic.

Chairman PROXMIRE. Let me get back to some of the substantive findings you made.



According to your estimate in 1970 alone, and I quote: "The use of the governmental credit power resulted in hidden but very real subsidies in excess of \$5 billion."

You were using the \$5 billion figure as a budgetary cost of credit subsidies; is that correct?

Mr. WEIDENBAUM. Yes, sir.

Chairman PROXMIRE. You say the magnitude of these hidden subsidies is extremely substantial, yet it is very rare that the cost of credit subsidies comes up in debate about these programs and there are very few people in Washington who realize that the cost is so high. Why is this the case?

Mr. WEIDENBAUM. Because these subsidies are hidden and some of the subsidies in other areas, say, as shown in the staff study, subsidies to the Merchant Marine, subsidies of commercial aviation—first of all, they are labeled subsidies. The Congress appropriates for them; but these are truly hidden subsidies.

The Congress, to my knowledge, has never appropriated—to cite a figure—\$226 million of subsidy for Public Law 480 activities in 1970 which is the figure I have in my prepared statement as to the subsidy element of that part of the Commodity Credit Corporation's activity, its burden—it never sees the light of day.

Chairman PROXMIRE. Well, then, you call this—you go further than saying it is simply hidden; you say—

My testimony deals with a most pernicious type of subsidy—the hidden subsidy which the public may not be aware of, which often Congress may not have intended.

I am interested in your use of the term "pernicious" which means highly injurious or destructive. In what way are credit subsidies destructive? You say some of them may be good but you say they can be and apparently some of them are destructive?

Mr. WEIDENBAUM. I am concerned, when I look at the overall flow of savings in the American economy that so much, such an increasing portion of the total process whereby the savings of the American economy are translated into investment, essentially through our private capital markets, that such an increasing share of this saving is funneled through governmental credit programs. In a sense we have come a very long way toward socializing a basic portion of our private enterprise system, a very fundamental part, that is, the use of capital, and why? Because the subsidies in these governmental credit programs make them so appealing to the specific beneficiaries involved.

Chairman PROXMIRE. Then you go on to say some of these subsidies are unintended?

Mr. WEIDENBAUM. Yes, sir.

Chairman PROXMIRE. Why are these subsidies unintended? How do they come about? How do you get an unintended subsidy?

Mr. WEIDENBAUM. My example is the rural electrification.

Chairman PROXMIRE. It certainly intended that. This Senator always supported it and as I told you before it served a tremendous purpose in electrifying our farms and increasing our efficiency and helping our whole society and economy.

Mr. WEIDENBAUM. Of course, I may have no quarrel with the program per se. My point, however, is that when the Congress initially

authorized the REA program, it set up an interest rate which was not a subsidy rate; it was the same interest rate, to the nearest percent, that the Treasury itself was paying at the time. I would contend it was a technical shortcoming. Instead of saying, in other words—

Chairman PROXMIRE. Let me just interrupt to say throughout the years we have become very sensitive to that, very much aware. It is hard to pick up an issue of the Readers Digest without reading an attack on the REA as a subsidy that was costing the taxpayer a lot of money and making the farmers rich.

I think most Members of Congress realize that 2 percent REA is a huge subsidy although it is not perhaps as big as you point out today.

Mr. WEIDENBAUM. I can point out in most recent years the Treasury particularly has been urging congressional committees when drafting governmental credit program legislation not to specify a specific interest rate, which—well, 7.5, for example—would be too high at the present time for some cases, but to gear the interest rate to what is the then current Treasury borrowing cost. In other words, as the Treasury borrowing costs go up, the interest rate would go up. As the Treasury borrowing costs go down, the interest rate would move with it. Thus the unintended windfall would be avoided.

Chairman PROXMIRE. My time is up. I will be back.

Congressman Blackburn.

Representative BLACKBURN. Thank you, Mr. Chairman.

Thank you, Mr. Weidenbaum. I appreciate your coming before this committee. Your dispassionate and logical approach to things is a refreshing experience—

Mr. WEIDENBAUM. Thank you.

Representative BLACKBURN (continuing). In contrast to some of our Populist arguments I have been exposed to recently.

I have some questions here I am going to submit to you which deal with some testimony we had last week, but what I want to ask you about right now is table 1 in your prepared statement in the estimated subsidy. The first year on the top item, social security assistance—

Mr. WEIDENBAUM. Yes.

Representative BLACKBURN. Is that \$1 million?

Mr. WEIDENBAUM. That's right. It is rounded to the nearest million; it is \$1 million.

Representative BLACKBURN. So then if we capitalize that \$1 million at what, 7.5 percent—

Mr. WEIDENBAUM. Yes, sir.

Representative BLACKBURN (continuing). I come out with \$9 million. I am not clear why its capitalized value varies. For example, down here under the Farmers Home Administration we have \$1 million and we have a capitalized value of 17 percent.

Mr. WEIDENBAUM. It varies for two reasons: First of all, \$1 million is a rounded figure; but, second, the capitalized figure also varies with the length of loan. In other words, the longer the loan the bigger the capitalized value.

Representative BLACKBURN. I understand. What you are saying here is that when Congress subsidizes an interest rate for some sector of our economy, not only are they obligating the taxpayers for a direct appropriation to the extent of that subsidy but they are also creating a diversion in the capital market to the extent that lenders who might

otherwise be loaning money out to someone to build a factory, for instance, will be lending their money to this subsidized loan program?

Mr. WEIDENBAUM. Yes, sir. In fact, in fiscal 1970 if you add up all of these Government credit programs they account for at least one-third of the total flow in and out, through the private capital markets. In other words, one-third of the flow of savings into investment is influenced or controlled now by Government.

Representative BLACKBURN. You give a figure in your prepared statement here of \$167 billion. We are dealing with a \$1 trillion economy and a roughly \$200 billion budget. I will have to agree with you, in fact, I have been expressing concern in recent months, about the lack of control over these interest subsidy programs. I appreciate your calling to our attention the diversion of capital that frankly I had not considered.

There is another facet to this, too, isn't there? For example, under our low interest home subsidy programs, 235 and 236, we have almost given a blank check to HUD. Now, next year we are going to have to appropriate funds to whatever extent we build houses. This is going to create a pressure on the Federal Reserve to relax monetary policy in order to meet the bonds the Treasury is going to have to issue because we are not collecting more money than we are paying out. In effect, it is not just a question of Congress losing control of its programs; we are also creating problems for the Federal Reserve Board in dealing with monetary policy; don't you think that is true?

Mr. WEIDENBAUM. Yes, sir. In fact, over the years often these Government credit programs which have been immune both from fiscal controls as well as from fiscal controls as well as from monetary policy have interfered with the effectiveness of monetary policy in a sense because with the Government backing they have assured access to private capital. The impact of credit stringency is that much tougher on the rest of the economy, on the unprotected, and on the truly private borrowers.

Representative BLACKBURN. I think the chairman has pointed out that the private home market is one of the first to feel the impact when you start tightening up on monetary supply while at the same time some sectors are being subsidized.

Mr. WEIDENBAUM. Yes, sir.

Representative BLACKBURN. So, in effect, there is a leverage that works there to magnify the effect against the unsubsidized sector of the market?

Mr. WEIDENBAUM. Oh, definitely.

Representative BLACKBURN. Do you have any broader suggestion as to how we might clamp a ceiling on some of these programs? We have a housing act, for example, that we will be marking up next month and I frankly would like to say to Secretary Romney that I think we ought to have a cooling off period on some of these programs to see how effective they are going to be before we just continue this mushroom-like spread of subsidized housing.

Mr. WEIDENBAUM. I don't want to infer that I am an expert on housing finance but you want a broad—

Representative BLACKBURN. At least I want the Congress, which has created these programs, to have some method of controlling them and as it is now we literally give them a blank check and it is getting out of hand.

MR. WEIDENBAUM. I have really two types of suggestions: For those programs outside the budget, enact legislation like the Federal financing bank bill the Treasury prepared for Congress consideration last month; but for those programs in the budget, such as the one you just mentioned, I think it is important that when the Congress reviews the annual increment of the program the agency make fully available to it not just the annual costs but the total long-term commitment that the Treasury and the taxpayers are making by virtue of congressional action on that increment.

Representative BLACKBURN. Well, as it is now, what we are doing is looking at the narrow end of the funnel and we are not even taking into account the big end of the top which is going to be the ultimate expense involved if these programs go through to fruition. We are also experiencing some bad practical problems with some of our housing programs, that is, foreclosures and things of this sort, so the funnel will be much larger than we originally anticipated. If the program went through happily without foreclosures it still would be a tremendous obligation on the taxpayer but now it is being complicated and increased by foreclosures, vandalism, and so forth, so we could be getting into a deeper problem than we anticipated.

MR. WEIDENBAUM. I know Secretary Romney is very concerned about this very point.

Representative BLACKBURN. Again, I want to thank you for your very thoughtful work here. We have had questions from other panels dealing with tax policies and because you have been associated with the Treasury Department I am going to submit some written questions dealing with treating capital gains as ordinary income and imputed rents—a rather startling suggestion last week—and I would like to have it explored a little further; also some other written questions about the deductibility of interest on your home loan and that sort of thing. But I will submit those written questions to you. And, again, thank you.

(The following information was subsequently supplied for the record:)

RESPONSE OF MURRAY L. WEIDENBAUM TO ADDITIONAL WRITTEN QUESTIONS POSED  
BY REPRESENTATIVE BLACKBURN

*Question 1. There have been numerous proposals to tax as ordinary income all realized capital gains. Could you give us your general reaction to these proposals and, additionally, describe for us some of the rationale which lies behind the special taxation of realized capital gains?*

Answer. As I understand them, the purpose of the proposals to tax realized capital gains as ordinary income is to improve the horizontal equity of the system—that is, to ensure that taxpayers with equal amounts of income will pay the same amount of tax. There are several important rationales for the existing treatment of capital gains. First of all, until income-averaging was introduced into the Internal Revenue Code, the capital gains treatment was necessary to avoid the kind of situation where a taxpayer held an asset for many years but paid tax on the full gain in the year of sale, thus perhaps putting him temporarily in a high tax bracket which did not truly reflect his income position over the years.

More fundamentally, the capital gains treatment affords an important incentive to investment and, hence, to economic growth and employment. As in the case of some of the items discussed below, simply removing this provision and doing nothing else would interfere with achieving important national objectives other than tax equity.

Personally, I do have difficulty with defining long-term capital gains as involving assets held for a minimum of six months. Logic would seem to dictate that transactions completed within the space of one year are not long-term in nature.

*Question 2. Elimination of the tax exemption for interest from state and local government bonds has been suggested. Again, could you give us your reaction to this proposal as well as stating your understanding of the economic basis for this exemption. Could you contrast the use of this exemption as a means for assisting state and local governments in meeting their financing requirements with the federal interest subsidy programs for state and local obligations which have been proposed from time to time?*

Answer. I must frankly admit that until I joined the Treasury in 1969 and had occasion to meet and work with governors, mayors, and other state and local officials, I shared the widespread notion among economists that tax-exempt state and local bonds were merely a loophole that should be eliminated. However, it soon became apparent to me that, given the fiscal pressures facing these governments, assistance of this type was necessary to shore up our federal form of government.

Although I am intrigued by the possibility of substituting Federal interest rate subsidies, I am concerned about maintaining the independence of our local institutions.

I need to add, however, that over the coming decade, there may not be sufficient savings made available through the tax-exempt bond market to meet the capital needs of state and local governments. They may need to tap other investors, such as pension funds, that are not attracted by the tax incentive.

*Question 3. The elimination of deductions from gross income for the expenses of real property taxes and mortgage interest on homes has been advocated. Could you give us your reaction to this proposal, as well as your understanding of the various social and economic bases for enactment of the deductions in the first place?*

Answer. When I examine the problems of our central cities and the growing abandonment of housing, I am impressed with the need to maintain incentives to individual home ownership. Simply eliminating the existing tax treatment would exacerbate a situation which already is extremely difficult.

Once again, my own view is to illuminate the costs of these special provisions, as well as the size and distribution of their benefits. Only when this is done can we make sensible comparisons among the alternative ways of achieving public objectives.

*Question 4. Several witnesses have proposed taxing transfer payments as ordinary income. This would of course include all welfare payments and, I assume, Social Security payments. Could you give us your reactions to these suggestions?*

Answer. In part, this runs counter to the trend of recent years—particularly the Tax Reform Act of 1969—to take poor people off the tax rolls and also thus to avoid the burden of filling out tax returns.

In theory, I do see merit in subjecting all income—including social security payments—to taxation. In practice, I doubt whether the expense to the taxpayer and to the government would be worth it. Many retired people with no other income would still owe no tax, but they would be subject to some more governmental forms. For those who would be subject to taxation, there would be problems of separating out new income from the return of the payroll tax payments (which already were subject to tax).

*Question 5. Elimination of most itemized deductions and of the standard deduction on personal income tax returns has been proposed. Would this elimination, in your opinion, make any substantial contribution in achieving what some consider to be more "equity" in the distribution of our income tax burdens?*

Answer. Eliminating itemized deductions, in my opinion, would be a most unfortunate mistake. This provision is necessary to promote private solutions via private institutions to many of the problems facing our society. The alternative to this support of charitable and related contributions would likely be either more public operation or direct support of charitable and educational institutions.

Chairman PROXMIRE. Mr. Reuss.

Representative REUSS. As always, Mr. Weidenbaum, whether in public office or in private life, your testimony has been of the highest order and I am grateful to you.

Mr. WEIDENBAUM. Thank you.

Representative REUSS. Among the many excellent points you make is that the credit programs may result not only in a subsidy by giving somebody a 2-percent interest rate when it costs 7.5 percent to borrow the money, but maybe it is robbing Peter to pay Paul. If credit is at all tight, if one person gets credit that means somebody else doesn't, and there is a particularly good example of that in the housing field that you did not specifically mention and I wonder whether you are familiar with it. This became particularly pertinent 2 or 3 years ago when there was a great shortage of mortgage credit, and as everybody recognized, would-be homebuilders in this country simply couldn't get credit. We have had for some years as part of the foreign aid program a program of Government guarantees to contractors, principally American contractors, who build very substantial middle-income housing overseas. So you had at a time of credit stringency the situation where Americans of moderate income couldn't get a mortgage loan with which to build or buy a house, but in far off parts of the world people of much greater relative income were enabled to build or buy quite substantial homes.

These were not low-income houses at all.

My question is, had there been the kind of orderly, column-by-column disclosure of the impact of our credit programs, do you think the average American would-be homeowner would have allowed that sort of situation to go on?

Mr. WEIDENBAUM. Frankly, Mr. Reuss, I am not familiar with that program. I just made my personal contribution to the balance-of-payments situation by doing very little foreign traveling; but certainly your point in general, I think, is a very important one, that the taxpayer, the citizen, needs to have better knowledge of where his tax money is going.

Representative REUSS. I want, finally, to turn to a subject which has been a particular interest of yours, though it is not much in your testimony this morning; that is, the subject of revenue sharing. To this you devoted many valiant hours during your official period here in Washington, and through no fault of yours, you were not able to bring it off during your era.

However, more recently several things have happened: One, Chairman Mills of the House Ways and Means Committee has come up with a variant of revenue sharing, although not called by that name, which to me sounds very good. And, in addition, the housing subcommittee of the House has a metropolitan area oriented version of revenue sharing which also has much to be said for it. Both of these will shortly be the subject of hearings and markup sessions.

My question is, Do you think that revenue sharing has some chance of enactment in this year of 1972, from where you sit?

Mr. WEIDENBAUM. Yes, I do. I have been very pleased to learn of the introduction of the bill by Congressman Mills and, really, I can't get very excited as to the exact label he pastes on it. I think, as I have analyzed it, that it may be the second best revenue sharing bill I have come across. Seriously, I very much hope it does get favorable consideration by the Ways and Means Committee and ultimately by the Congress because it would provide a very effective method of using a portion of Federal revenues to help our hard-pressed State and local

governments and that, as you and I have both written and said, is the essence of the concern with revenue sharing.

I was not aware of the action of your subcommittee but I am delighted to hear that, too, sir.

Representative REUSS. Thank you very much.

Chairman PROXMIRE. Mr. Weidenbaum, in June 1970, at the same time he created the Productivity Commission, President Nixon also established the Regulations and Purchasing Review Board. In his words, the Board's objective was that "all Government actions will be reviewed to determine where Federal purchasing and regulations drive up costs and prices." In other words, this was the way we would find out how the Federal Government's policies could be tailored not to be as inflationary as they have been, or to make them less inflationary.

The Board, however, has not even remotely exercised the authority granted by the President. As far as my staff can determine, it has issued only one progress report, more than a year ago, and it has not even met since August of last year.

Mr. Houthakker, a member of the Board's working committee during his tenure at the Council of Economic Advisers, said to this subcommittee last Thursday:

I have to concede that the board has not lived up to its promise at all. \* \* \* the board has never met frequently for reasons which I don't pretend to understand.

Mr. Houthakker went on to cite certain examples of Government programs and subsidies that contribute to inflation.

Since Mr. Houthakker's testimony on this matter, which I found very upsetting, we have dug further into the activities of this mysterious Board that rarely meets and appears to keep no records of what it does. The cat is out of the bag; the Regulations and Purchasing Review Board does nothing. This administration has no program for dealing with Government-induced inflation.

Mr. Weidenbaum, you were associated with that Board. Why has there been no administrative leadership and action in this important area?

Mr. WEIDENBAUM. First of all, Mr. Chairman, I don't think it was a very mysterious Board.

Chairman PROXMIRE. Mysterious in that it is a board created to combat Government-induced inflation and it rarely meets, and issues one progress report in a year and seems to accomplish nothing.

Mr. WEIDENBAUM. Of course, the fact that the Board may not have met since I left the administration I can't take responsibility for that.

Chairman PROXMIRE. When did you leave?

Mr. WEIDENBAUM. In August.

Chairman PROXMIRE. No wonder; now we have our answer.

Mr. WEIDENBAUM. But I should point out that at the second level, the one that Mr. Houthakker and I functioned on, and at our staff levels, there were many activities, studies, meetings, deliberations on the part of this Board.

Chairman PROXMIRE. What became of all that activity? What did it do?

Mr. WEIDENBAUM. It examines—it has examined—various specific Government legislation and regulations which might tend to have an inflationary impact. Frankly, I share Mr. Houthakker's disappoint-

ment that the Board per se has not yet come up with any specific recommendations. I would, speaking personally, urge you not to knock the Board but to sort of jack it up, sort of give it a little more encouragement.

Chairman PROXMIRE. One way to jack it up is to knock it. After all, if the Government is going to have an anti-inflation program and we have heard an awful lot about phase I and II and the freeze and the effect it has had on business, big and small, and labor unions and so forth, but the one place where the Government could be effective is in its own policies; and here it is doing nothing. You say you are disappointed; Mr. Houthakker is disappointed; we are really disappointed.

Mr. WEIDENBAUM. I wouldn't be too harsh on the Board because, after all—

Chairman PROXMIRE. You were on it? [Laughter.]

Mr. WEIDENBAUM. Aside from that, its major subject matter was legislation passed by the Congress so that, in a sense, we are all implicated.

Chairman PROXMIRE. Yes; but it was set up by the President and it was supposed to be an active and aggressive Board. I don't think the Congress should be exonerated at all; I think we are very responsible undoubtedly for our actions.

Mr. WEIDENBAUM. I should point out, Mr. Chairman, that during that period the President did act on one of the areas where Government legislation and regulations truly have an inflationary bias; frankly, it even gets to questions of concentrations of economic power that Senator Harris raised and I refer to here, to the Davis-Bacon Act. That, I think, is a prime example of hidden subsidies. I should point out that even though the staff study is a very commendable, comprehensive document, but I don't recall—I may have missed it—any analysis in it of the very large amount of regulatory subsidies in the area of labor.

I happened to read on the plane coming in last night a new study just issued on the Davis-Bacon Act which shows a tremendous amount of hidden subsidies available that accrued as a result of the—

Chairman PROXMIRE. How about giving us a cost estimate on it? You say a tremendous amount. How big is it?

Mr. WEIDENBAUM. I didn't do the study but this is a study by Prof. John Gould of the University of Chicago which was just published by the American Enterprise Institute. I would be glad to give you my copy.<sup>1</sup>

Chairman PROXMIRE. Can you tell us what he estimates as a result of the Davis-Bacon Act?

Mr. WEIDENBAUM. As I say, I don't have a number in here but what he does show, citing General Accounting Office studies and others, is that the administration of the Davis-Bacon Act has an upward bias in terms of wage rates. It represents, as the author points out, a departure from the general principle that the Government should award contracts to the lowest responsible bidder. The Davis-Bacon Act is a force the other way.

Chairman PROXMIRE. I think that is right. I think that even its defenders, and there are many, and I think it has some merit as well

<sup>1</sup> See study beginning on p. 161.



as some basis for criticism, would have to agree that you can't raise wages without having some effect on costs and this does tend to be inflationary. We would like to know how much and then measure that against the benefits which those who support the Davis-Bacon Act claim for it.

Mr. WEIDENBAUM. The reason I mentioned it, frankly, Mr. Chairman, is I heard discussion earlier this morning about the extent to which so many of these subsidies benefit business, benefit the upper income brackets. To be sure in many cases that is so. This is an illustration of the other point, that many of these subsidies are to other elements of the society, particularly to organized labor. Many of these subsidies are to middle-income groups and I don't think we should ignore that.

Chairman PROXMIRE. Well, I think that is right.

Apropos of this last point you made, last Friday we received some devastating evidence that most tax subsidies and special benefits go to the rich. In the case of realized capital gains, for example, taxpayers with incomes over \$1 million a year receive \$641,000 in annual capital gains benefits, while taxpayers with incomes between \$5,000 and \$10,000 a year receive \$8 in annual capital gains benefits.

Did you realize that these tax subsidies go primarily to the upper-income classes?

Mr. WEIDENBAUM. Yes, sir. In fact, I was pleased to make available this material and the staff study so indicates, when I was in the Treasury. I should point out, however, that in so many of the discussions of these tax, special tax provisions, we tend to overlook the reason for them. After all, I don't think that either the Treasury ever recommended or certainly that the Congress voted these special tax provisions because they wanted a loophole, wanted a tax windfall; but they wanted to achieve an important public objective.

Chairman PROXMIRE. Exactly; you are right about that. I think it is a very, very helpful observation. We got that from Mr. Pechman: we got that from the other experts who testified. I think that is true. What we are saying, however, is that we ought to have that clearly on the record and we also ought to know the costs and I think we ought to know, as Senator Harris pointed out, who does get these benefits. As you say, they are for a specific purpose in every case but the purpose, it seems to me, ought to be brought out every year and examined in the light of the costs.

Mr. WEIDENBAUM. Absolutely.

Chairman PROXMIRE. Are we achieving the purpose? Is there a benefit calculated to achieve? Is that being achieved?

Mr. WEIDENBAUM. Yes, sir, but there is very little attention to the benefit aspect.

Chairman PROXMIRE. I think that is true.

Mr. WEIDENBAUM. For example, capital gains are a very important way of encouraging savings, investment, economic growth, and employment.

Chairman PROXMIRE. Can you say anything about who benefits from credit subsidies?

Mr. WEIDENBAUM. Yes, sir. In my prepared statement I indicate that the largest area of subsidies are in the housing area. In a sense the homeowner.

Chairman PROXMIRE. Which homeowner—low, high income, middle income?

Mr. WEIDENBAUM. I haven't done an income class distribution. It would vary. In other words, there are subsidy programs for low-income housing.

Chairman PROXMIRE. Don't you think this is the kind of thing we should ask, and demand to the extent we can, from the Treasury that they tell us where these benefits are? It may well be that these housing benefits do benefit the low income; that is certainly one of the intentions of it. I think most Members of Congress who acted in this area thought that is what they were doing but I have also heard some criticism that has not been the effect.

Mr. WEIDENBAUM. That is right.

Let me say that as of the time I was in the Treasury this information did not exist in the Treasury. It is not a question of sitting—

Chairman PROXMIRE. Why should it be? Is it in HUD?

Mr. WEIDENBAUM. The information has to be collected; it isn't available, to my knowledge, at the present time.

Chairman PROXMIRE. This is a matter that could be collected, however, rather easily; isn't it?

Mr. WEIDENBAUM. I think it should be collected. I wouldn't, frankly, say easily. Having made my own attempts to estimate the distribution of the benefits of Government programs by income class, this is an extremely difficult undertaking.

Let me cite the housing one that you mentioned, the low-income housing.

Ostensibly, the benefit is to the low-income recipient. Undoubtedly, housing investors, speculators, et cetera, have participated in the program to some benefit. How do you divide the benefit to the investor from the benefit to the homeowner? It is not apparent to me, but this points out the difficulties involved. In other words, you are going to get, if you go this route, and I frankly hope you do, a variety of estimates.

You can sit down three competent analysts, and they will come up with at least three different—if they are not working together—sets of estimates of the benefits.

Chairman PROXMIRE. That doesn't mean, however, we shouldn't try to determine that; does it? Shouldn't we try to get the estimates and find out what the variances are so we will be at least in some position to know what the effect of our policies are? They are enormously expensive and in not achieving our end it seems to me we have good reason to change it or eliminate it.

Mr. WEIDENBAUM. Yes, sir; I am just alerting you to the point there is a cost to this.

Chairman PROXMIRE. Right.

Mr. WEIDENBAUM. It is not free information; it is not information that is currently available.

Representative BLACKBURN. I would like to inject this observation at this point, Mr. Chairman, that I think is very pertinent to the present part of our discussion:

In looking into these housing programs, we find that a developer can buy acreage at, say, \$300 an acre and that acreage may be far removed from any major city and it may be entirely unattractive for housing

purposes; but because of the very existence of 235 financing program, this developer is able to get FHA to approve the lot that he is going to build his house on, to have a value of, say \$1,500, perhaps, or even \$2,000.

Now, if it were not for the 235 housing program, that acreage would still be worth \$350 an acre but the developer by putting in the utilities which are nowhere near as costly as the value of the land after it is developed for residential purposes, himself enjoys a windfall as a direct result of this Federal program. So I think that the point should be made that the subsidy that we are paying supposedly to help the home purchaser is creating windfalls for promoters and I certainly don't think that was the intention of the Congress when we developed the program.

So there are some general areas that I think Congress is going to have to give some very serious thought to when we take the simple thing we are going to subsidize for the home purchaser and then we find the program in practice has far wider implications than what we anticipated. I just want to make that observation.

Chairman PROXMIRE. It is very valuable information. The staff tells me there is, to their knowledge, information in HUD about distribution of benefits that has not been made available to the public or to Congress or other members of the executive branch; but we ought to get that information and I think the observation of Congressman Blackburn is most helpful because it does only go to speculators. We would like to have the best experts we can get to make the best judgments they can make.

Previous witnesses have said that a subsidy is bad if it is for an objective that no longer merits public support, or if the subsidy is inefficient or inequitable in its economic effects.

Would you please identify for the subcommittee what you consider the worst Federal subsidy programs, looking at credit and other financial matters?

Mr. WEIDENBAUM. Mr. Chairman, really, I find myself, and this is not often the case, unprepared. At the request of the committee, I put together what was really a fairly objective, at least tended to be a fairly objective, statement of the amount of subsidies in each of these programs. I really haven't tried to pass judgment on the merits of them. It would require a good deal more information than I currently have.

My point, really, is that now we see the true costs of these subsidies to the taxpayer. The next step is to come up with a comparable measure of the benefits of the program and only when we do that can we make a judgment.

Chairman PROXMIRE. Well, now, you are not a pussyfooter by any means—I know you are not—and, of course, you now don't have to worry about being under any administration; you are an independent economist who can make his own observations.

Mr. WEIDENBAUM. No, I found—

Chairman PROXMIRE. I know you are not. What I am trying to say is, I am sure you don't want to make a judgment before you have the facts on which to base it and you are saying you would like to have more information before you make that kind of a judgment. What I would like to say, however, is you have studied many of these things and you know far more about them than most of us, and I would hope

to the extent that you could identify some of these subsidies that are not warranted, are not justified, you would say so, because this is one way of getting a good strong debate going and a beginning to get action in cutting out wasteful subsidies.

It is very hard to get attention on this kind of thing. Now here we have, I think, one of the most important subjects facing the country. No other hearings in Washington at the present time. This isn't being covered by the television network; it is being covered to some extent very ably by the press but on a limited basis and one of the reasons, I am sure, is because it is very, very hard to get the public to understand this.

I noticed in the hearings Friday we had four of the top tax experts in the country and these were men who were identified in the Washington Post as public wits. I looked over at the television group toward the middle of the hearings and there were four television men covering this. Three of them were fast asleep; you could almost hear them snore. It was not that these fellows were not fine men, were not interested in covering it; it was so complicated they just lost it; it was beyond them. If it is beyond experts and technicians of this kind it is certainly beyond the public.

One way of getting public attention on this is to say what is bad and what is hurting the public. I know you like to be objective and fair, and have every bit of analysis first, and you should be. But, to the extent that you can make any judgment like that, we would surely welcome it.

Mr. WEIDENBAUM. Let me offer you a suggestion, Mr. Chairman, and you might title this a defense of subsidies. In many cases—tax subsidies particularly, but some credit subsidies—these represent a private sector alternative to a direct Government expenditure program.

The alternative to the subsidy may be an increase in the scope, the size, of an existing or setting up of a new governmental agency and expenditure program.

Now, I am not prepared to say, without examining the facts, whether that shift should be made; in other words, in some cases I would assume that the subsidy benefit to the private beneficiary exceeds the cost that would be incurred to the Treasury if the program were done by the Government.

Chairman PROXMIRE. I think that is exactly right. There is no question about it. There are many subsidy programs, including tax subsidies, which are eminently justifiable and should be continued. The trouble is, however, we don't know, we don't know what the costs are; we don't know what the benefits are; we don't reexamine them from year to year; we don't analyze them carefully; we just are not in a position to evaluate them.

So there are undoubtedly billions and billions of dollars of tax expenditures and billions of dollars of other subsidies which are not justified and which, if we had the information and the public had the information, we would be in a position to make a decision but we are not getting that.

Mr. WEIDENBAUM. Let me be specific. You asked for some specifics and it is because I examined this study—

Chairman PROXMIRE. I don't think the information would knock out all subsidies by any means and it shouldn't because, as you say, some of them are good, but we would knock some of them out.

Mr. WEIDENBAUM. I think the one priority subsidy that should be considered is the Davis-Bacon Act and I would be pleased to submit this study if you so desire which makes a very effective case for eliminating that subsidy.

Chairman PROXMIRE. I would be happy to receive that; very helpful. (The aforementioned study follows:)

SPECIAL  
ANALYSIS

**DAVIS-BACON ACT**  
**The Economics of**  
**Prevailing Wage Laws**

JOHN P. GOULD



**AMERICAN ENTERPRISE INSTITUTE**  
*FOR PUBLIC POLICY RESEARCH*

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## **Acknowledgments**

In doing the research for the paper I have benefited greatly from the help of Mr. George Burman with whom I have discussed many of the results contained herein and of Professor Roman Weil who commented on an earlier draft of this paper. Further acknowledgment is due Yale Brozen, Ronald Ehrenberg, Damodar Gujarati, Marvin Kusters, and Michael Moskow whose research is reported and discussed in the following pages.

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Special Analysis Number 15, November 1971

Price \$3.00 per copy

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Library of Congress Catalog Card No. L.C. 70-185048



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## Introduction

The Davis-Bacon Act requires payment of "prevailing" wages and fringe benefits to workers on federal government contracts for the construction of public buildings or public works. The required wage rates are those determined by the secretary of labor to be prevailing in the city, town, village, or other civil subdivision of the state in which the work is performed. Numerous other laws incorporate the Davis-Bacon prevailing wage requirement for federally *assisted* projects such as highways, airports, housing, hospitals, schools, and defense facilities. This paper is a survey of the key literature dealing with the economic and social consequences of this legislation.

In 1970, wage increases for 3 million union members in the construction industry averaged between 15 and 18 percent. This rapid increase led President Nixon, on February 23, 1971, to suspend the prevailing wage law, better known as the Davis-Bacon Act. The President noted in his proclamation that the nation was confronted by a set of conditions involving the construction industry which, when taken together, created an emergency situation. About one month later, on March 29, 1971, the President announced that the construction industry had agreed to a voluntary system of constraints aimed at keeping negotiated construction industry wages at an annual level of about 6 percent. The Davis-Bacon Act was reinstated at that time. The purpose of this paper is to examine the role which this apparently influential piece of legislation—the Davis-Bacon Act—plays in the determination of construction industry wages. We begin with a brief examination of the behavior of wages (union and nonunion) in contract construction in recent years.

Table 1 shows that in recent years, the rate of increase in wages in the contract construction industry has been appreciably greater than the increase in wages in the private nonagricultural sector. Moreover, while the rate of wage increase in the total private nonagricultural sector and in the manufacturing sector moderated somewhat in 1970 this was not so in contract construction. In fact, construction wages increased 9.2 percent between 1969 and 1970, almost a full percentage point faster than the 8.3 percent increase in 1968-69.

There are, of course, many possible explanations of this large wage increase in the construction industry: the demand for housing, the relative amount of unionization, the number of newly trained craftsmen that are available to the industry, the amount of seasonality in construction work, and the effect of government policies, to name a few. This paper deals only with the last of these, or more specifically, with the economic impact of the Davis-Bacon Act.

Table 1

PERCENTAGE INCREASE IN AVERAGE GROSS HOURLY EARNINGS IN  
SELECTED PRIVATE NONAGRICULTURAL INDUSTRIES, 1965-1970

Year	Total Private Nonagricultural	Manufacturing	Contract Construction
1965-66	4.5%	4.2%	5.1%
1966-67	4.7	4.0	5.7
1967-68	6.3	6.4	7.3
1968-69	6.7	6.0	8.3
1969-70	5.9	5.3	9.2

Source: *Economic Report of the President, 1971*, Council of Economic Advisers, Table C29, page 231; data provided by the U.S. Department of Labor, Bureau of Labor Statistics.

Perhaps one of the most surprising findings of this paper is that relatively little careful research has been done on the economics of the Davis-Bacon Act. Since the act appears to play a key role in understanding the wage structure of the construction industry, and since a substantial amount of related legislation is based on the logic of the Davis-Bacon Act, it is particularly unfortunate that economists have not done more to further our understanding of this law. In the review of the literature that follows, the author has leaned very heavily on the work of Professor Damodar Gujarati and on the work of Ronald G. Ehrenberg, Marvin Kosters, and Michael Moskow.

My main objective in this paper has been to pull together and interpret the major existing evidence on the economic impact of the Davis-Bacon Act—primarily the studies by Gujarati and Ehrenberg. In addition, however, I have endeavored to construct a formal means of accounting for the impact of Davis-Bacon legislation on average construction industry wages. This work is discussed in detail in Appendix A.<sup>1</sup>

<sup>1</sup> Unfortunately, it has proved difficult to get satisfactory empirical estimates of the key variables in the formal model and it is not easy to give an answer to the question of just how much average wages are influenced by Davis-Bacon determinations and contracts. It is hoped that others will be encouraged to contribute to the solution of this problem.

## The Davis-Bacon Act

The Davis-Bacon Act was enacted on March 3, 1931 for the purpose of protecting local wage rates on federal construction from the competition of lower wage, nonlocal labor. Amendments to the act included "prevailing" fringe benefits in the definition of prevailing wages, and charged the secretary of labor with the responsibility of determining the prevailing wages acceptable for bids on federal projects. The Davis-Bacon Act represented a dramatic reversal of earlier federal policy of awarding government contracts at the lowest cost to the taxpaying public.

Proponents of the act were concerned about the tendency for nonunion and nonlocal contractors to underbid contractors in high wage and highly unionized areas. According to the proponents, successful bidders often imported labor from the South and other lower wage regions, thereby contributing to unemployment and reducing wages in the higher wage locality. Congressman Bacon described this position in highly emotional language during debate on the bill:

A practice has been growing up in carrying out the building program where certain itinerant, irresponsible contractors, with itinerant, cheap, bootleg labor, have been going around throughout the country "picking" off a contract here, and a contract there, and local labor and local contractors have been standing on the sidelines looking in. Bitterness has been caused in many communities because of this situation.

This bill, my friends is simply to give local labor and the local contractor a fair opportunity to participate in this building program.

I think it is a fair proposition where the Government is building these post offices and public buildings throughout the country that the local contractor and local labor may have a "fair break" in getting the contract. If the local contractor is successful in obtaining the bid, it means that local labor will be employed because that local contractor is going to continue in business in that community after the work is done. If an outside contractor gets the contract, and there is no discrimination against the honest contractor, it means that he will have to pay the prevailing wages, just like the local contractor.<sup>1</sup>

### Wage Differentials—A Brief Digression

In what follows, several aspects of the Davis-Bacon Act shall be considered in detail. To provide initial perspective, however, it is worth digressing at this point to consider some of the reasons for wage differentials in a market economy. Numerous wage differentials can be found in the United States—between industries, occupations, races, sexes, skills, individuals with different amounts of schooling,

<sup>1</sup> *The Legislative History of the Davis-Bacon Act* (Washington: Government Printing Office, 1962), p. 1.

union and nonunion labor, geographic locations, and so on. The reasons for these differentials are almost as varied as the differentials themselves. In some cases the wage differential reflects differences in productivity. In other instances, the differential is countered by differentials in nonpecuniary aspects of the job. High paying jobs may in some cases be more hazardous or more demanding. Low paying jobs may provide nonmonetary rewards such as a pleasant climate, a nicer work environment, or greater employment security. Differences in wages can also arise from changes in market structures. For example, unions may be able to raise relative wages by limiting entry of workers into the craft or trade, by superior bargaining power, and by other means.<sup>2</sup>

These kinds of differentials may exist in a static equilibrium but wage differentials also play a major role in the dynamics of a changing economy. Consider the case of two geographically distinct markets. Suppose that demand for housing in one of these markets increases relative to the other market. The initial effect of this change in relative demand will be to raise construction wages in the high demand market relative to wages in the low demand market. If this wage differential is large enough, workers in the low demand market will be encouraged to offer their services in the high demand market. This supply response has two desirable effects. First, it serves to equilibrate wages in the two markets by raising wages in the low demand market and lowering wages in the high demand market. This spreads the wage benefits of increased demand to all workers. Second, it facilitates the resource flow that consumers have shown a preference for by their change in demand—relatively more housing is built in the high demand market and relatively less housing is built in the low demand market.

This example illustrates the central role that wage and other price differentials play in determining resource flows in a market economy. If wages are not permitted to respond to changing market conditions many undesirable consequences can result. Suppose that wages are frozen by law at the high relative level that obtains immediately following the increase in demand in the above example. Workers will be encouraged to refuse lower paying jobs while attempting to search for work in the high wage market. Since wages in this market are not allowed to drop, there will not be enough demand to absorb these additional workers. One result may be an increase in frictional unemployment as workers spend more time searching for the higher paying job opportunities.<sup>3</sup> In addition, the flow of resources from the low demand market to the high demand market is thwarted by the wage freeze and it can be demonstrated that this results in a welfare loss to the society in general.

Another consequence of such a frozen wage differential is to create an artificial inequity in wages. As noted in the example, the shift of workers to the high wage area lowers wages there and raises wages in the low wage area. By freezing wages

<sup>2</sup> Professor H. G. Lewis has provided a very careful and scholarly analysis of the effect of unions on relative wages in his book, *Unionism and Relative Wages in the United States* (Chicago: The University of Chicago Press, 1963).

<sup>3</sup> This phenomenon is described by Professor John J. McCall in his recent article "Economics of Information and Job Search," *Quarterly Journal of Economics*, LXXXIV, 1 (February 1970), pp. 113-26.

in the high demand area more workers are forced into the low demand market, thereby reducing their wage rate relative to what it would be in an unconstrained market. This inequity runs directly counter to the claims of fairness that proponents of the Davis-Bacon Act make for it. In an unconstrained market, increases in demand tend to spread across the economy to the benefit of all workers. Constraints on wage changes concentrate the gains of additional demand on some workers at the expense of lower wages of others. Certainly, it is unfair to categorize workers as cheap labor, who, for reasons beyond their control, find themselves in low demand areas. I shall return to these and related problems later in this study.

### Prevailing Wage Laws—State and Federal

The Davis-Bacon Act provides that workers employed on every contract in excess of \$2,000 to which the United States or the District of Columbia is a party for construction, alterations, or repair of public buildings or public works shall be paid no less than the rates determined by the secretary of labor to be prevailing on similar projects in the area in which the work is performed. The rates include prevailing fringe benefits or the cash equivalent of such benefits. (See text of the act, Appendix C.)

Several states had enacted similar legislation before the 1931 Davis-Bacon Act. Kansas was the first state to do so in 1891.<sup>4</sup> Six other states, New York, Oklahoma, Idaho, Arizona, New Jersey, and Massachusetts, enacted prevailing wage laws between 1897 and 1931. Subsequent to the federal law in 1931, a large number of states also enacted such laws covering state construction expenditures. There are currently 35 such state laws as noted in Table 2.

**Table 2**  
STATES WITH PREVAILING WAGE LAWS

Alaska	Illinois	New York
Arizona	Indiana	Ohio
Arkansas	Kansas	Oregon
California	Kentucky	Pennsylvania
Colorado	Maine	Rhode Island
Connecticut	Maryland	Tennessee
Delaware	Massachusetts	Texas
District of Columbia	Missouri	Utah
Florida	Montana	Washington
Hawaii	Nevada	West Virginia
Idaho	New Hampshire	Wisconsin
	New Mexico	

Source: Ronald G. Ehrenberg, "The Economic Import of Davis-Bacon Type Legislation: An Economic Study," unpublished paper, March 1971.

<sup>4</sup> Professor David B. Johnson discusses the history of prevailing wage legislation in his article, "Prevailing Wage Legislation in the States," *Monthly Labor Review*, LXXXIV, 8 (August 1961), pp. 839-45.

It is interesting to compare the extent of unionization between states with prevailing wage laws and states without such laws.

**Table 3**  
EXTENT OF UNIONIZATION IN STATES WITH AND WITHOUT PREVAILING WAGE LAWS, 1966 <sup>a</sup>

	Union Membership in 1966 (in thousands)	Union Membership as a Percent of Nonagricultural Employment
States with prevailing wage laws . . . . .	15,777	30.9%
States without prevailing wage laws . . . . .	2,331	19.8%
Total U.S. . . . .	18,108	28.8%

<sup>a</sup> This table is computed from data in the *Statistical Abstract of the United States: 1968*, 89th ed. (Washington: Government Printing Office), p. 239.

The finding that states with prevailing wage laws have almost 60 percent greater relative union membership than states without such laws does not mean that these laws "cause" union membership. However, as we shall see later, there is evidence that unions benefit from such laws and it is not surprising that states with presumably stronger unions are also more likely to have such legislation. It is interesting to note also that 10 of the 15 states (i.e., 67 percent) with no prevailing wage laws do have right-to-work laws whereas only 9 of the 35 states (i.e., 26 percent) which have prevailing wage laws also have right-to-work laws.

#### **Other Federal Laws Requiring Davis-Bacon Prevailing Wage Determination**

A substantial number of laws have been passed that incorporate the Davis-Bacon prevailing wage determination provisions for federally *assisted* projects although the federal government itself is not a party to such contracts. As will be shown in the next section, there has been a tendency for the Department of Labor to make inappropriately high determinations of the prevailing wage in a number of cases. This policy has had unfortunate consequences that tend to defeat the main purpose of many of the laws that embody Davis-Bacon prevailing wage clauses.

To illustrate this problem, consider the following example pointed out by Professor Yale Brozen of the University of Chicago in a recent paper.<sup>5</sup> Professor Brozen observes that the Davis-Bacon Act negates the purpose of Section 221(d) (4) of the National Housing Act which is "to assist private industry in providing housing for low and moderate income families and displaced families." The Na-

<sup>5</sup> Professor Brozen has cited a large number of situations in which Davis-Bacon determinations have had disastrous economic consequences in his paper "The Davis-Bacon Act: How to Load the Dice Against Yourself" (unpublished manuscript), University of Chicago, 1971.

tional Housing Act offers subsidies to reduce interest costs in projects serving such families.<sup>6</sup> However, the high wage rates set in the Labor Department's "prevailing" wage determinations on such projects reduces, and in some cases eliminates, the subsidy benefits to these families. Professor Brozen cites the case of a developer of a high-rise apartment complex to be built in Prince George's County, Maryland. After building two such apartments, the developer received an interest cost subsidy to build a third for moderate income families. In order to receive the subsidy, however, the builder was required to pay Davis-Bacon wage rates. He argued that if he were to pay these higher wages, the rentals on the new moderate income building would be *higher* than those in the two buildings already built. Before the developer's objection was dealt with by the Wage Appeal Board, a new determination was made by the Wage Determination Division that further raised the minimum wage rates and eliminated any hope of building the low-rent housing.

As the following list of laws containing prevailing wage clauses indicates, there are a large number of instances in which the Davis-Bacon determination "spills over" into other programs. The cases in which this spillover works against, and sometimes destroys, the basic objective of these other laws can be multiplied manifold.

#### FEDERAL LAWS REQUIRING "DAVIS-BACON TYPE" PREVAILING WAGE DETERMINATIONS <sup>a</sup>

1. The Davis-Bacon Act (40 U.S.C. 27ca-276-a-7) and as extended to the Federal-Aid Highway Act of 1956 (23 U.S.C. 113).
2. Copeland Act.
3. The Contract Work Hours Standards Act.
4. National Housing Act.
5. Hospital Survey and Construction Act.
6. Federal Airport Act.
7. Housing Act of 1949.
8. School Survey and Construction Act of 1950.
9. Defense Housing and Community Facilities and Services Act of 1951.
10. United States Housing Act of 1937, as amended.
11. Federal Civil Defense Act of 1950.
12. Area Redevelopment Act.
13. Delaware River Basin Compact.
14. Health Professions Educational Assistance Act.
15. Mental Retardation Facilities Construction Act.
16. Community Mental Health Centers Act.
17. Higher Educational Facilities Act of 1963.
18. Vocational Educational Act of 1963.
19. Library Services and Construction Act.

<sup>6</sup> These subsidies are achieved by having the government guarantee the loan which makes it possible to obtain a lower rate of interest (because the lender's risk is reduced) than would otherwise be the case.

<sup>a</sup> The legislation is listed in chronological order and is complete through 1968. Source: Ronald G. Ehrenberg, *op. cit.*



20. Urban Mass Transportation Act of 1964.
21. Economic Opportunity Act of 1964.
22. Public Health Services Act.
23. Housing Act of 1964.
24. The Commercial Fisheries Research and Development Act of 1964.
25. The Nurse Training Act of 1964.
26. Elementary and Secondary Education Act of 1965.
27. Federal Water Pollution Control Act.
28. Appalachian Regional Development Act of 1965.
29. National Technical Institute for the Deaf Act.
30. Housing and Urban Development Act of 1965.
31. National Foundation on the Arts and the Humanities Act of 1965.
32. Public Works and Economic Development Act of 1965.
33. High Speed Ground Transportation Study.
34. Water Quality Act of 1965.
35. Heart Disease, Cancer and Stroke Amendments of 1965.
36. Mental Retardation Facilities and Community Mental Health Centers Construction Act Amendments of 1965.
37. Vocational Rehabilitation Act Amendments of 1965.
38. Clean Air and Solid Waste Disposal Act.
39. Medical Library Assistance Act of 1965.
40. Veterans Nursing Home Care Act.
41. National Capital Transportation Act of 1965.
42. Alaska Centennial—1967.
43. Model Secondary School for the Deaf Act.
44. Allied Health Professions Personnel Training Act of 1966.
45. Demonstration Cities and Metropolitan Development Act of 1966.
46. Federal-Aid Highway Act of 1966.
47. Air Quality Act of 1967.
48. Elementary and Secondary Education Amendments of 1967.
49. Vocational Rehabilitation Amendments of 1967.
50. National Visitor Center Facilities Act of 1968.
51. Juvenile Delinquency Prevention and Control Act of 1968.
52. Federal-Aid Highway Act of 1968.
53. Housing and Urban Development Act of 1968.
54. Health Manpower Act of 1968.
55. Vocational Rehabilitation Amendments of 1968.
56. Public Health Service Act Amendment (Alcoholics and Narcotics Addict Rehabilitation Amendments of 1968).
57. Vocational Education Amendments of 1968.

## Administration of the Davis-Bacon Act

There are two specific aspects of the Davis-Bacon Act to be considered in the balance of this study. The first deals with the means by which "prevailing" wages have been determined by the Department of Labor. The second has to do with the economic effects of imposing prevailing wage rates on construction contractors rather than seeking out the lowest bidders without predetermining their wage rates. These issues are not unrelated, but most of the critical analysis of the Davis-Bacon Act has focused on the former question and has not taken up the problem of the desirability of the act *per se*. This section considers the problem of determining prevailing wages.

### Procedure for Predetermination of Wage Rates

The procedure for predetermination of prevailing wages was formalized in a directive from the secretary of labor in December, 1963.<sup>1</sup> It applies to the Davis-Bacon Act and a large number of other acts, including the National Housing Act, the Federal-Aid Highway Act of 1956, the Federal Water Pollution Control Act and "such other statutes as may from time to time, confer upon the secretary of labor similar wage determining authority."<sup>2</sup> The secretary's regulations define the prevailing wage as follows:

- (a) The rate of wages paid to the *majority* of the workers in that classification in the area in which the work is to be performed.
- (b) In the event that there is not a majority of workers paid the same rate, then the prevailing rate is that paid to the largest numbers of workers provided that this constitutes *at least 30 percent* of those employed.
- (c) In the event that less than 30 percent of those employed receive the same rate, then the *average* rate where the average rate is obtained by adding the hourly rates paid to all workers in the classification and dividing by the total number of such workers.

In determining the prevailing wage, the solicitor of labor is to obtain wage rate information from several sources.<sup>3</sup> The types of information considered include:

- (a) Statements showing wage rates on projects;

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<sup>1</sup> These directives are contained in Title 29 of the Code of Federal Regulations.

<sup>2</sup> The other acts are contained in Table 3.

<sup>3</sup> In 1970, the responsibility for prevailing wage determinations was moved from the Office of the Solicitor of Labor to the Office of the Assistant Secretary for Wage and Labor Standards.

- (b) Signed collective bargaining agreements;
- (c) Wage rates determined for public construction by state and local officials pursuant to prevailing wage legislation;
- (d) Information furnished by federal and state agencies; and
- (e) Whenever the solicitor deems that the data on hand are insufficient to make a determination, he may have a field survey conducted in the area of the proposed project for the purpose of obtaining sufficient information upon which to make a determination of wage rates.

Section 1.6 of Title 29 of the Code of Federal Regulation contains two other relevant provisions:

- (a) In making wage rate determinations, projects completed more than one year prior to the date of request for the determination may, but need not, be considered.
- (b) If there has been no similar construction within the area in the past year, wage rates paid on the nearest similar construction may be considered.

While these conditions are explicit about many aspects of the procedure for prevailing wage determinations, the Branch of Wage Determination in the Department of Labor has a substantial amount of discretion in making determinations. In practice, it appears that an overwhelming proportion of wage determinations carry union wage rates regardless of area or type of construction. This is often a consequence of the "majority" rule, the "30 percent" rule, and the Section 1.6 authorization of determinations on the basis of the "nearest similar construction." The bias in favor of union wage rates is also likely to be a consequence of the very large number of determinations that have to be made each year and the resulting pressure for expedience in making determinations.

### **The Branch of Wage Determinations**

Between 1945 and 1961 the number of wage determinations issued annually by the Branch of Wage Determinations rose from 3,884 to 49,740. A single determination requires wage rates for anywhere from 10 to 300 job classifications and 100 classifications per determination is not at all unusual.<sup>4</sup> In his testimony before the Roosevelt Committee in 1962, Charles Donahue, who was then solicitor of labor, noted:

Unfortunately, I find that the staffing of the wage determination branch has not kept pace with the growth of its work load. At present (1962) the branch consists of only 19 professional and 40 clerical employees. This problem requires immediate attention and we are taking appropriate action to remedy this situation.

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<sup>4</sup> See the testimony of Charles Donahue, Solicitor of Labor, before the Roosevelt Committee in 1962; U.S. Congress, House, Special Subcommittee on Labor of the Committee on Education and Labor. *Hearings, A General Investigation of the Davis-Bacon Act and Its Administration*, 87th Congress, 2nd Session, 1962.

Five years later, on November 29, 1967, Secretary of Labor W. Willard Wirtz said in a letter to Mr. Henry Eschwege of the U.S. General Accounting office:

Determining wage rates under the Davis-Bacon Act for residential work has been a troublesome problem and will continue to be a problem so long as the Department of Labor lacks adequate facilities for collecting wage information in various parts of the country. As you know, wage rates in the construction industry in any area vary from time to time, and up-to-date information is essential. The Department of Labor currently (1967) has a staff of 70 persons engaged in wage determining here in Washington and, also, 5 field representatives handling special matters as required. *These are not nearly enough for accurate determinations, particularly in the residential field. (Underscore added.)*<sup>5</sup>

Three years later, in another review of inappropriately high wage rate determinations, the General Accounting Office noted that by January 1970, the Labor Department still had not increased the wage determination staff contrary to the expressed intent of Secretary Wirtz in 1967.<sup>6</sup>

The picture presented is quite clear. For reasons of staffing or otherwise, the wage determinations made by the Department of Labor under the Davis-Bacon Act and related laws have displayed an inappropriate and a persistent upward bias. Between 1962 and 1970, there have been no less than six reports by the General Accounting Office that have pointed this out and the problem has been acknowledged and deplored by high level officers of the Department of Labor in congressional testimony and elsewhere. Nevertheless, despite the widespread agreement on the facts, there is no evidence of any effective action to eliminate the inaccurate and in many cases economically harmful wage determinations that have been made under the Davis-Bacon Act.

### General Accounting Office Studies

The six studies of the General Accounting Office mentioned in the last paragraph have documented many instances in which Davis-Bacon wage determinations have been unreasonably high. A few of these studies are summarized below.

#### (a) Capehart Housing in Quantico, Virginia <sup>7</sup>

In March 1960 the Navy Department requested a specific determination for a Capehart housing project for the Marine Corps School in Quantico, Virginia, a community about 35 miles south of Washington, D. C. Its request noted that an earlier Labor Department determination contained wage rates very much in excess

<sup>5</sup> Report to the Congress of the United States by the Comptroller General, "Need for More Realistic Minimum Wage Rate Determinations for Certain Federally Financed Housing in Washington Metropolitan Area," transmitted to Congress on September 13, 1968.

<sup>6</sup> Report to the Congress of the United States by the Comptroller General, "Construction Costs for Certain Federally Financed Housing Projects Increased Due to Inappropriate Minimum Wage Rate Determinations," transmitted to Congress on August 12, 1970.

<sup>7</sup> See Comptroller General's Report, "Review of Wage Rate Determinations for Construction of Capehart Housing at the Marine Corps Schools, Quantico, Virginia," transmitted to Congress on June 6, 1962. This case is also discussed by D. M. Gujarati in his paper "The Economics of the Davis-Bacon Act," *Journal of Business*, 40 (July 1967), pp. 303-16.

of a current area wage survey conducted by the officer in charge of this construction project. Table 4 compares these two sets of wage rates. It indicates that the Davis-Bacon determinations ran anywhere from 28 to 100 percent greater than the estimated "average" wages for the designated crafts in the area wage survey. On the basis of this information, the Labor Department issued a new determination with lower wage rates. Within a month, however, in response to union protests, the Labor Department reinstated the *original* wage rates. The Navy protested, but a hearing examiner decided in favor of the union rates, and these became the final determination. In its review of this case the General Accounting Office concluded:

- The Labor Department's determination did *not* represent prevailing wages.
- The inaccurate rates determined for this project raised wage costs by \$1.1 million or about 15 percent of the total contract cost.

Professor Gujarati notes in his paper that, subsequent to the Quantico decision, three additional determinations for projects in the area carried local rates that were lower than the union rates. While it is comforting to know that this downward

**Table 4**  
**QUANTICO PROJECT WAGE DATA**

Craft	Davis-Bacon <sup>a</sup>	Wage Rate Survey	Percentage that Davis-Bacon Exceeds Mid-Point of Area Survey Wages
Laborer	\$2.42	\$1.00-2.40	43%
Carpenter	3.67	2.00-3.50	33
Cement Mason	3.87	1.75-3.00	63
Bricklayer	4.15	2.75-3.75	28
Plumber	4.16	2.00-3.00	66
Electrician	4.45	2.00-3.50	62
Plasterer	4.10	1.60-3.00	78
Painter	3.84	1.50-2.35	100

<sup>a</sup> Rates are union rates for commercial construction in metropolitan Washington, D. C. Source: D. M. Gujarati and Comptroller General's Report, *op. cit.*

adjustment was made for later projects, the adjustment provides further evidence that the Quantico decision was much too high. It is particularly alarming that the Labor Department insisted on the union rates when it had clear and unambiguous evidence that such rates were seriously in error.

#### **(b) Federally Financed Building Construction in New England**

The General Accounting Office examined Davis-Bacon wage determinations for federally financed construction in New England in 1962. In his report to the Congress, the comptroller general stated:

Our review of the determinations by the Department of Labor of minimum wage rates to be paid to mechanics and laborers employed on construction

of federally financed building projects in selected New England areas disclosed that many of the rates were improperly established at the higher rates negotiated by labor organizations and building contractors rather than at the lower rates prevailing on private construction in the project areas. Also, wage rates determined for certain crafts in connection with a federally-assisted low-rent housing project in Massachusetts were on a level with the negotiated rates normally paid on commercial-type building construction rather than equal to the lower rates paid on similar private housing construction in the locality. *Our review showed that these unrealistic determinations were based on inadequate information obtained by the Department on wage rates in these areas, and we believe that the Department has not complied with either its own regulations or the intent of the Davis-Bacon Act that wage determinations be based on the wage rates prevailing for similar construction in the locality.* (Italics added.)<sup>8</sup>

The GAO report presented several interesting findings about Davis-Bacon determinations in New England.

1. Wage determinations for power equipment operators on federally financed projects throughout Maine were found to be higher than those prevailing in Maine. The Davis-Bacon rates corresponded to union-negotiated rates in Boston, Massachusetts.

2. GAO noted several cases in which regular employees of nonunion contractors worked at or about the same time on private projects and federal projects and were paid at higher rates on the federal projects. Comparative wages provided in the GAO report showed that employees working on concurrent projects earned wages on federal projects that were from 68 to 221 percent higher than on private projects.

3. GAO found that the Department of Labor included previous Davis-Bacon rates in the information it used to determine prevailing wages on new contracts, thereby carrying any earlier errors forward. In the words of the GAO report:

The [Labor] Department's survey disclosed that the average hourly rate for laborers, while working only on private construction in 1963 was \$1.92 or 33 cents an hour lower. The 1962 wage decisions showed that the minimum rate for truck drivers was the negotiated rate of \$2.15, but the Department's survey disclosed that the prevailing rate for truck drivers was \$1.50 an hour . . . or 65 cents an hour lower than the negotiated rate. The difference in interpretation of the Department's recent survey stems from the fact that we have excluded from the survey data the wage rates paid on federally financed projects which were subject to prior wage decision of the Department employing the negotiated rate.<sup>9</sup>

4. The GAO report noted that ". . . as has been shown in this report and in associated reports to the Congress, it has been the practice of the Department to determine the higher negotiated rates paid on commercial type building construction as the minimum rates for federally financed housing construction instead of the

<sup>8</sup> Comptroller General's Report to Congress, "Wage Rates for Federally Financed Building Construction Improperly Determined in Excess of the Prevailing Rates for Similar Work in New England Areas" (January 1965).

<sup>9</sup> *Ibid.* p. 15.

lower rates prevailing for similar private housing construction in the project areas."<sup>10</sup> To estimate the difference attributable to this application of incorrect rates, the General Accounting Office surveyed costs of construction of 29 apartments in Middlesex, Suffolk, and Norfolk counties, Massachusetts that were comparable to a low-rent housing project in Middlesex which carried a Davis-Bacon determination. The GAO did not choose the lowest possible rates but rather applied the Labor Department's determination rule to the survey data. The results are shown in Table 5. On the average over all the reported crafts, the Davis-Bacon determination was 33 percent greater than the GAO survey wage. It should be emphasized that the GAO figures are "prevailing" wages and are quite likely to be above the minimum wage in each craft.

**Table 5**  
**NEW ENGLAND STUDY WAGE DATA**

Craft	Department of Labor Determination	GAO Private Housing Survey	Difference
Masons	\$4.12	\$3.81	\$0.31
Carpenters	3.85	3.04	0.81
Ironworkers	4.26	2.51	1.75
Lathers	3.90	2.75	1.15
Painters	3.30	2.28	1.02
Plumbers	4.20	3.14	1.06
Plasterers	4.12	3.50	0.62
Laborers	2.90	2.23	0.67
Steamfitters	4.20	3.00	1.20
Soft floor layers	3.85	3.08	0.77
Tile setters	4.05	2.58	1.47
Truck drivers	2.80	2.40	0.40

Source: GAO report, *op. cit.*, p. 19. Wage rates are reported to the lowest cent.

**(c) Other GAO Studies**

The findings of the Quantico study and the New England study were essentially repeated in GAO studies in 1968 and 1970.<sup>11</sup> These studies made some other relevant points. First, GAO found that, because of the high rates determined by the Labor Department on the Davis-Bacon construction, open shop, private housing contractors were sometimes reluctant to bid on such contracts. To do so

- (a) would disrupt a company's labor force because workers on government jobs would be paid greater hourly rates than those on private jobs, and

<sup>10</sup> *Ibid.* p. 21.

<sup>11</sup> Comptroller General's Reports to the Congress "Need for More Realistic Minimum Wage Rate Determinations for Certain Federally Financed Housing in Washington Metropolitan Area" (September, 1968) and "Construction Costs for Certain Federally Financed Housing Projects Increased Due to Inappropriate Minimum Wage Rate Determinations" (August 1970).

- (b) would create hardship and morale problems when workers' wage rates decreased after the government job was completed and they returned to work on private construction jobs.

This reaction of nonunion contractors to the excessive Davis-Bacon rates has two undesirable consequences. It limits the competition for government contracts, thereby raising the cost of these contracts. In addition, it suggests that the Davis-Bacon contracts tend to segregate the labor market to the disadvantage of nonunion workers.

Second, GAO found the wage information file of the Department of Labor was inadequate to determine appropriate wage rates. GAO also found that the department had conducted wage surveys in 1957 and 1961 showing that nonnegotiated wage rates prevailed on private construction single-family homes in the Washington metropolitan area. The report goes on to state:

Nevertheless, most of the current wage data in the Department's files at the time of our review consisted of data from negotiated wage agreements submitted by local labor organizations. We did not find in the files adequate current data showing the specific construction projects on which the negotiated wage rates prevailed, the specific construction projects on which nonnegotiated rates prevailed, or the number of workers being paid negotiated and nonnegotiated wage rates.<sup>12</sup>

Third, GAO also noted that the department's determinations displayed a significant inconsistency. The department determined *different* classifications and minimum rates for similar low-rent public housing projects in the District of Columbia and the nearby town of Alexandria, Virginia. The District of Columbia project was classified as commercial building construction, whereas the department classified the similar project in Alexandria as residential housing.

### **Professor Gujarati's Study**

As can be readily seen from the above sampling of the comptroller general's studies, a large number of specific cases have been identified in which the Labor Department's Davis-Bacon wage rate determinations were seriously in error on a number of counts. Since, in several cases, the General Accounting Office's review focused on determinations that were known to be in error, it is not easy to decide from these studies alone just how widespread is the phenomenon of inappropriate determinations. Fortunately, Professor Damodar Gujarati conducted a broader sampling study of Davis-Bacon determinations for his doctoral dissertation at the University of Chicago in 1965.<sup>13</sup> His study covered 300 counties from the 50 states, the District of Columbia and Puerto Rico. In order to obtain more precise information on Labor Department determinations in cases where unionization was low, the counties were distributed among the areas in inverse proportion to the extent of unionization in these areas.

<sup>12</sup> Comptroller General's Report to Congress (September 1968), *op. cit.*, pp. 22-23.

<sup>13</sup> Damodar Gujarati, *The Economics of the Davis-Bacon Act*, doctoral dissertation at the Graduate School of Business, University of Chicago, 1965. A *Journal of Business* article based on this dissertation has been cited above.



**Table 6**  
**DAVIS-BACON DETERMINATIONS BY CRAFT AND TYPE OF**  
**WAGE RATE PREVAILING**

Craft and Type of Construction	Union Wage Rate				Survey Wage		Payment Evidence		To- tal *	p *	$\sigma_p$ †
	Local	Contig- uous coun- ties	Non- contig- uous coun- ties	State- wide	Union	Non- union	Union	Non- union			
<b>Bricklayer:</b>											
Building .....	58 (30.6)	52 (27.5)	45 (23.8)	7 ( 3.6)	1 (1.3)	—	18 (9.5)	8 ( 4.2)	189	.9674	.0142
Heavy and highway.....	2 ( 6.1)	8 (24.2)	6 (18.2)	9 (27.3)	1 (3.0)	—	3 (9.1)	4 (12.1)	33	.8981	.0265
<b>Carpenter:</b>											
Building .....	69 (32.6)	55 (26.1)	35 (16.6)	7 ( 3.6)	1 (0.3)	3 (1.4)	16 (7.6)	25 (11.8)	211	.9299	.0175
Heavy and highway.....	12 (10.0)	15 (12.6)	8 ( 7.5)	39 (32.7)	—	3 (2.5)	9 (7.5)	32 (27.2)	119	.7558	.0390
<b>Plasterer:</b>											
Building .....	50 (27.3)	63 (34.5)	37 (20.2)	7 ( 3.8)	3 (1.6)	—	17 (9.3)	6 ( 3.3)	183	.9798	.0100
Heavy and highway.....	1 ( 5.6)	6 (33.4)	5 (27.7)	5 (27.7)	—	—	1 (5.6)	—	18	1.0000	.0000
<b>Electrician:</b>											
Building .....	54 (26.0)	68 (32.7)	45 (21.7)	9 ( 4.3)	2 (0.9)	1 (0.6)	17 (8.4)	11 ( 5.4)	207	.9658	.0142
Heavy and highway .....	6 (11.8)	11 (21.5)	16 (31.5)	13 (25.5)	—	—	2 (3.8)	3 ( 5.9)	51	.9383	.0360
<b>Painter:</b>											
Building .....	60 (28.4)	57 (27.1)	37 (17.5)	10 ( 4.7)	2 (0.9)	1 (0.5)	10 (4.7)	33 (16.2)	210	.8901	.0221
Heavy and highway.....	8 (14.7)	15 (27.9)	10 (18.5)	11 (20.5)	—	—	2 (3.2)	8 (14.7)	54	.9059	.0450
<b>Plumber:</b>											
Building.....	54 (27.8)	58 (29.9)	39 (20.1)	11 ( 5.7)	3 (1.5)	—	17 (8.8)	12 ( 6.2)	194	.9545	.0150
Heavy and highway.....	4 —	10 —	6 —	6 —	—	—	6 —	1 —	33	.9696	.0140
<b>Power equipment operator:</b>											
Building .....	53 (27.9)	51 (26.9)	38 (20.0)	28 (14.5)	1 (0.6)	—	13 (6.8)	6 ( 3.3)	190	.9769	.0110
Heavy and highway.....	11 —	9 —	9 —	46 —	1 —	1 —	11 —	25 —	113	.7461	.0400
<b>Common labor:</b>											
Building.....	60 (27.5)	52 (23.9)	42 (19.3)	12 ( 5.5)	2 (0.9)	—	13 (5.9)	37 (17.0)	218	.8534	.0237
Heavy and highway.....	15 (11.6)	14 (10.9)	10 ( 7.8)	39 (29.5)	—	1 (0.8)	3 (2.3)	48 (37.1)	129	.6722	.0396
<b>Cement mason:</b>											
Building .....	60 (30.2)	57 (28.6)	38 (19.1)	11 ( 5.5)	—	—	14 (7.0)	19 ( 9.6)	199	.9289	.0175
Heavy and highway.....	11 (12.8)	14 (16.3)	12 (13.9)	21 (24.4)	1 (1.2)	—	7 (8.1)	20 (23.3)	86	.8549	.0380

Source: D. M. Gujarati, *Journal of Business*, *op. cit.*, p. 305.

Notes—Figures in parentheses are percentages. Building construction includes commercial, residential, and building parts of missile construction. Heavy and highway construction includes interstate highways, dams, bridges, etc.

\* The number of determinations for which wage rates were requested. Not all determinations required rates for all the nine crafts.

† The standard error of the estimate  $p^*$ .

Professor Gujarati's work sheds some important light on the following questions. (1) What actual locality is used for the purpose of making the wage determinations? (2) What proportion of determinations carry union wage rates? (3) What kinds of data are used to make the determinations?

Gujarati collected data on 372 wage determinations for nine crafts in the sample counties. A detailed breakdown of these determinations is provided in Table 6 which has been reproduced from Gujarati's paper. This table provides several interesting findings:

- The fraction  $p^*$ , which is the weighted proportion of determinations carrying union wage rates, is close to one in most instances. This means that an overwhelming number of determinations carried union wage rates. Professor Gujarati found it very difficult to measure the actual extent of unionization by craft except in the case of common labor. He estimates that about 59 percent of common laborers are unionized. This compares to Davis-Bacon union wage determinations of 85 percent and 67 percent for building and heavy and highway construction, respectively.
- Perhaps the most disturbing evidence is the extent to which union wage rates are imported into a locality from noncontiguous counties or from state-wide wage data. Professor Gujarati notes that Section I of the Davis-Bacon Act defines the area of construction as the "city, town, village, or other civil subdivision of the state in which the work is performed" and, further, that the legislative history of the act does not indicate that this definition was intended to be construed so loosely as to permit "leap-frogging." The intent of the act was to protect *local* wage rates, not to raise these local rates by basing determinations on rates from other, higher wage paying areas. Nonetheless, the survey data indicate that a substantial fraction of the Davis-Bacon determinations uses prevailing wages from noncontiguous counties. According to this data, about 25 to 38 percent of the building construction determinations were based on rates from noncontiguous counties, and 46 to 73 percent of the heavy and highway construction determinations were based on noncontiguous county rates. In some cases the Labor Department went beyond state boundaries for "prevailing" wage data, as was noted in the GAO report on construction in New England.
- Professor Gujarati found that Department of Labor wage surveys were not generally used to determine prevailing wages. Indeed, in his sample of 372 wage determinations, he found that surveys were made for only eight projects (or slightly more than 2 percent). On the other hand, unions were prompt to submit wage rates data and this accounted, in part, for the strong preponderance of union wage determinations.

Further analysis of “noncontiguous county” determinations suggests the following additional findings:

- Union wage rates determinations based on rates from noncontiguous counties occur with greater frequency the smaller the population of the county where the construction actually occurs. This is illustrated in Chart 1, which is adapted from Professor Gujarati’s data. Gujarati suggests that population may be a good proxy for the extent of unionization and, if this be so, it appears that union wages are imported into nonunion localities by the Davis-Bacon determinations.
- For each craft, Professor Gujarati calculated the average distance in miles that noncontiguous counties lie from the actual localities in which the noncontiguous wage data are applied. These distances ranged from 72 to 84 miles and Gujarati noted that this suggests that the Labor Department goes beyond a reasonable commuting distance in search of “prevailing” wages.

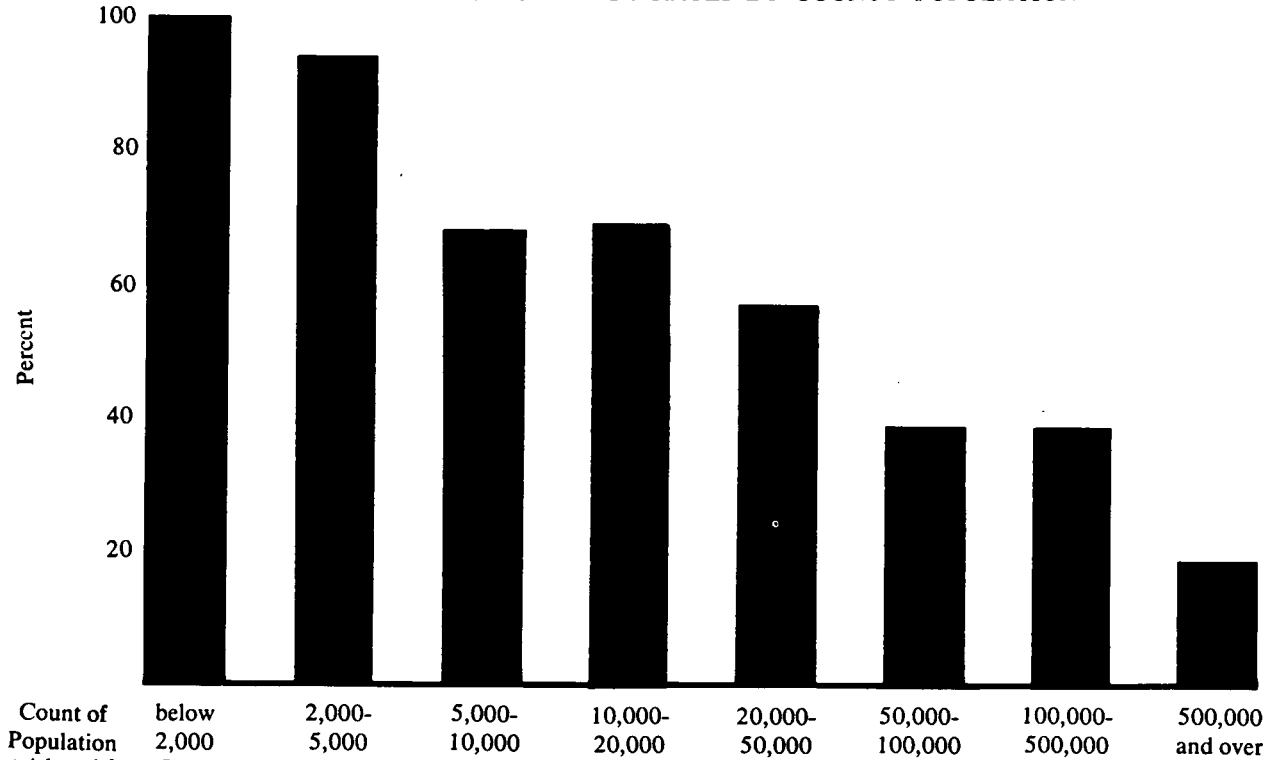
### Summary

This section reviewed the procedure and administration of Davis-Bacon determinations. The available evidence points very strongly in the direction that these determinations are inappropriately high in a substantial number of cases and do not conform with the intent of the act. The question of whether this is an unfortunate consequence of the huge burden imposed on the small number of people responsible for making wage determinations or whether it arises because of other reasons is entirely beside the point. Whatever the reason, the history of Davis-Bacon determinations indicates that these determinations have played an important role in strengthening the position of unionized construction labor, have tended to raise wages in the construction industry, and have spread high wages to various geographical localities irrespective of the wage rates that actually prevailed in those localities.

These problems appear to arise because of shortcomings in the determination of Davis-Bacon wage rates and this has led many investigators, such as the comptroller general, to recommend improvements in the wage determination procedure. It is, however, even more important to examine the validity of the act *per se*. There are two reasons for this. First, there is no evidence, despite several assurances to the contrary by Labor Department officials, that the determination procedure can ever be significantly improved. The poor record of determinations under the act is, in fact, strong evidence to the contrary. Second, it seems likely that the act would have undesirable consequences even if determination were made in strict accordance with the secretary of labor’s directive on wage determination procedures. The following sections take up this latter point in greater detail.

Chart 1

PERCENT OF DETERMINATIONS BASED ON  
OUT-OF-COUNTY UNION WAGE RATES BY COUNTY POPULATION <sup>a</sup>



<sup>a</sup> Adapted from Gujarati, *Journal of Business*, *op. cit.*, p. 309.

### Effects on Wages

The third section dealt with the upward pressure placed on wages by shortcomings in the procedure through which Davis-Bacon determinations are made. It is reasonable to expect, however, that the Davis-Bacon Act (and related prevailing wage legislation) would tend to increase wages *even if local wages were accurately reflected* in the determination of prevailing wages. This is because the Davis-Bacon Act *per se* may alter the market structure and the nature of competition in the industry. This possibility has been pointed out and investigated by Ronald Ehrenberg, Marvin Koster, and Michael Moskow in a preliminary version of a recent unpublished paper.

The analytical basis for this argument is easy to demonstrate in a hypothetical numerical example. The Davis-Bacon Act and related laws tend to make government demand (and government assisted demand) for construction projects relatively unresponsive (or inelastic) to wages. In other words, the act tends to decrease the government's bargaining power by disallowing the possibility of withholding contracts from high wage bidders if these bidders can establish their wage as "prevailing." This tendency is augmented by the bias toward inappropriately high prevailing wage determinations, but it would occur in any situation in which the government is prevented from searching out the lowest bidder. To see the effect of this inelastic demand on market wages, consider the following hypothetical example.

The first two columns in the table below show the amount of demand for man-hours of construction work in the private market at various wage rates. Suppose there are 9,000 man-hours available. Then demand will equal supply and the market will clear at a wage rate of \$3.00 an hour. If the government enters this market with a demand for 600 man-hours of labor at any price (column 3), the

**Table 7**  
HYPOTHETICAL EXAMPLE OF THE EFFECT OF INELASTIC DEMAND

Wage (per man-hour)	Private Market Demand (man-hours)	Government Demand (man-hours)	Total Demand (private and government)
\$2.00 .....	10,000	600	10,600
3.00 .....	9,000	600	9,600
4.00 .....	8,400	600	9,000
5.00 .....	7,980	600	8,580
6.00 .....	7,600	600	8,260

total demand (government and private) will be given by the figures in column 4. The market clearing wage for the 9,000 man-hours then rises from \$3.00 to \$4.00, and this rate will be paid by both the government and the private market. Several comments are in order about the phenomenon illustrated by this example.

The first thing to note is that, as long as the supply of man-hours is fixed (in this case it is fixed at 9,000 man-hours), some increase in wages would occur even if government demand were responsive to price. However, the increase in wages would be less pronounced if government demand were not completely inelastic. The second thing to note is that the assumption of fixed supply may be thought of as reflecting union restrictions on worker entry into the industry. As we have seen in Section III, the Davis-Bacon Act strengthens the unions' ability to dominate certain markets, since nonunion contractors are reluctant to bid for jobs at union rates. If the government sought the lowest bidder without predetermining wage rates, additional man-hours would become available and this increased supply would help to moderate the extent of wage increases. Suppose there are no unions and 600 additional workers enter the construction industry at a wage of \$3.25 an hour. In this case, the government demand would raise wages to only \$3.25 instead of the \$4.00 figure of the earlier example. It is interesting to note that when unions limit entry into the construction industry, Davis-Bacon determinations help the unions to raise private construction wage rates. A complete analysis of these issues is somewhat more involved but the main analytical structure of the model is made clear by this simple numerical example.

Ehrenberg, Kosters, and Moskow are developing a statistical model aimed at testing the effect of increases in the fraction of Davis-Bacon contracts on the relative wages of construction workers. Their preliminary statistical analysis, which is described in greater detail in Appendix B, may be summarized as follows: When unionization and construction growth are held constant, increases in the proportion of publicly financed construction in an area results in increases in the union scale wages of journeymen in the construction trades relative to wages of production workers in manufacturing. Ehrenberg, Kosters, and Moskow also find that increases in the proportion of publicly financed construction raises the average wage of helpers in construction trades relative to journeymen in these trades. This confirms Professor Brozen's observation, mentioned above, that Davis-Bacon determinations tend to set very high relative wages for workers in apprenticeship training programs. Brozen points out that this tends to discourage the use of apprentices on public construction projects.

Despite some ambiguities that are not unusual in empirical measurements in economics, these findings are in accordance with the studies of the General Accounting Office and the work of Professor Gujarati. The accumulated evidence points quite strongly in the direction that Davis-Bacon determinations (and determinations of related legislation) exert a powerful upward pressure on relative wages in the construction industry. This upward movement appears to take place directly in public construction and indirectly in private construction through the increased bargaining power which unions derive from the prevailing wage laws.

### **The Measurement of the Effect of Prevailing Wage Laws on Relative Average Wages**

While the evidence shows that prevailing wage laws have raised the relative wages of unionized construction workers, it is difficult to estimate just how large this effect has been. Data from studies by the General Accounting Office, show that inappropriate determinations ran as much as 100 percent above the "true" prevailing wage. But it is inappropriate to draw any general, economy-wide conclusions from these studies of specific determinations. There are both theoretical and empirical reasons for this which are brought into focus by the algebra in Appendix A. The main problems are summarized here. Suppose the Davis-Bacon Act was either suspended by presidential proclamation or repealed by the Congress. In order to predict the impact of such an action on average wages in the construction industry, at least the following questions would have to be resolved:

#### *Theoretical questions:*

What is the supply response of unionized labor likely to be? Will unions accept more unemployment to maintain existing wage levels or will union wage rates be permitted to decline relative to nonunion rates?

What is the supply response of nonunion labor likely to be? How quickly will workers from other occupations move into the building trades?

What is the private sector demand response likely to be? Will there be greater demand for building, houses, and commercial construction? If so, how much?

What fraction of public construction expenditures can be switched to the nonunion labor sector?

Would union rates obtain on some contracts in the absence of Davis-Bacon determination? If so, to what extent, and what would the wage rates be?

How many workers would be willing to remain in the unionized building trades if the differential between union and nonunion wage rates were reduced?

Would state and local governments retain their prevailing wage legislation if the federal law were repealed? What difference would this make?

#### *Empirical questions:*

What are the appropriate numerical values of the supply and demand elasticities for construction labor?

What fraction of total construction expenditures is public or publicly assisted?

What is the wage differential between union and nonunion labor in the building trades?

What is the fraction of unionized labor in the building trades?

This list could be easily extended, but it should be apparent from just these questions that it is quite difficult to get a very firm estimate on the precise impact

of prevailing wage laws on average wages. It is clear that a variety of estimates can be obtained depending on how the above questions are answered.

It is most tempting at this point to abandon any attempt to measure the exact impact of Davis-Bacon and related legislation on construction wages. However, ignoring a problem is not the way to solve it, so we will proceed to make an effort at getting at least a tentative answer. If nothing else, this should help identify the key issues and perhaps encourage others to tackle this important and interesting question. There will be no attempt, however, to provide a single estimate of the effect of Davis-Bacon determinations. Instead, we will try to examine the effects of different assumptions on the estimates obtained.

Appendix A provides a simple algebraic model of a two sector (union and nonunion) labor market which can be used to make some rough estimates of the kind of effects prevailing wage contracts might have on average wages. In view of the substantial complexities involved, a number of simplifying assumptions must be made in almost any model. There may be some virtue, therefore, in looking first at a very simple structure. Suppose that union and nonunion wage rates are unaffected by shifts in government demand. This is equivalent to treating union and nonunion labor supply curves as completely elastic. This situation could obtain if union members switched to the nonunion sector in response to a shift in government demand and fragmentary empirical evidence suggests that this might not be completely unrealistic. With the assumption of a completely elastic supply curve, the percentage increase in average construction industry wages is given by equation (4) of Appendix A. Suppose that union wage scales are about one-third greater than nonunion wages in the building trades (i.e.,  $r=1.33$ ). The following table presents the effect of Davis-Bacon determinations on average wage rates in construction for these assumptions and for various estimates of the proportion of construction expenditures that the government could shift to the nonunion sector,  $g$ , and various estimates of the extent of unionization in the construction industry,  $u$ .

Because of the wide range of values for the degree of unionism ( $u$ ) and fraction of government construction that could be removed from prevailing wage determinations ( $g$ ), the range of estimates of the effect on average wages shown in Table 8 runs from 3 percent to about 10 percent. These figures would be higher if union wage rates are more than one-third greater than nonunion wages and would be lower if union wage rates were less than one-third greater than nonunion rates.

Table 8 shows that the effect of prevailing wage determinations is larger, the larger the fraction  $g$ , and smaller, the larger the extent of unionization. The table also indicates that average wages are much more responsive to changes in the fraction of government prevailing wage contracts ( $g$ ) than they are to changes in the extent of unionization ( $u$ ). This suggests that the long-run effect of moving government contracts to the nonunion sector may be appreciable (assuming that a greater fraction can be so transferred in the long run than may be feasible in the first year or so).

It is interesting to consider another possibility. Suppose, instead of reducing union employment to maintain union wages, unions reduced wages to maintain union



Table 8

PERCENTAGE DECREASE IN AVERAGE CONSTRUCTION INDUSTRY WAGES (EQUATION 4 OF APPENDIX A) WHEN UNION WAGES ARE 33 PERCENT GREATER THAN NONUNION WAGES FOR VARIOUS PROPORTIONS OF GOVERNMENT CONSTRUCTION AND VARIOUS FRACTIONS OF UNIONIZATION IN THE INDUSTRY

Proportion of Unionization	Proportion of Government Construction Removed from Prevailing Wage Determinations (g)		
	g = .1	g = .2	g = .3
u = .25	3.1%	6.5%	10.0% <sup>a</sup>
u = .50	2.9	6.0	9.4
u = .70	2.8	5.6	8.8

<sup>a</sup> Calculated at 25 percent government contracts (g) since this would mean that *all* union workers are on government jobs and no larger percentage is possible.

employment. The extent of the wage reduction necessary to achieve this will depend on the elasticities of demand and supply in the union and nonunion construction markets.<sup>1</sup> Using the numerical values assumed in footnote 1, the percentage reductions in union wages needed to maintain union employment at initial levels are given in Table 9 for various values of the proportion of unionization and the proportion of government construction removed from prevailing wage determinations.

It is clear from Table 9 that the wage cuts needed to maintain union employment would be substantial in almost every case. They would be lower if demand were more elastic, but demand elasticities of 4 or greater would have to be assumed to move the entries in Table 9 down to very much lower levels. This suggests that it is unlikely that building trade unions would be able to maintain employment at existing levels if prevailing wage determinations were eliminated. Although the analysis is quite crude, it conforms with the strong desire (of the building trade unions) to maintain the Davis-Bacon Act.

<sup>1</sup> The assumption that union employment is maintained following the abandonment of prevailing wage laws means that the union supply elasticity,  $N_u^s$ , is zero. Suppose, in addition, that the other demand and supply elasticities are  $N_u^d = N_d^u = -1$  and  $N_g^s = 1$ . From equation 13 in Appendix A, the change in union wages needed to maintain union employment is then given by

$$w_u^* - w_u = \Delta w_u = -w_u \frac{g}{u - g},$$

and the percentage decrease is

$$\frac{\Delta w_u}{w_u} = - \frac{g}{u - g}.$$

Values of  $\frac{\Delta w_u}{w_u}$  for various levels of g and u are presented in Table 9.

Table 9

PERCENTAGE REDUCTION IN UNION WAGES WHEN THE GOVERNMENT REMOVES THE FRACTION  $g$  OF CONTRACTS FROM PREVAILING WAGE DETERMINATIONS NECESSARY TO MAINTAIN UNION EMPLOYMENT AT INITIAL LEVELS FOR VARIOUS VALUES OF THE EXTENT OF UNIONIZATION  $u^a$

Proportion of Unionization	Proportion of Government Construction Removed from Prevailing Wage Determinations		
	$g = .1$	$g = .2$	$g = .3$
$u = .25$	67%	<sup>(g)</sup> b	b
$u = .50$	25%	67%	b
$u = .70$	16%	40%	75%

<sup>a</sup> Assumes that the private sector demand elasticity for union labor is  $-1$ .

<sup>b</sup> The formula is, as noted in Appendix A, equivalent to a linear approximation to the demand curve around the initial price-quantity equilibrium. In the cases noted with b, this implies that union wages would actually have to become negative to maintain employment at the initial level. This absurdity means that we have to either assume that demand is much more elastic or that unions will refuse to attempt to maintain union employment at the initial level.

## Summary

It appears from the above survey of the literature on the Davis-Bacon Act that this has been extended far beyond the intentions of its framers and that it has had a variety of undesirable economic and social consequences which were not anticipated when it was passed in 1931. The central findings of this survey are itemized below.

1. At least six separate studies of prevailing wage determinations made by the General Accounting Office between 1962 and 1970 have shown that these determinations established inappropriately high minimum wages on a variety of federally financed and federally assisted projects. The validity of the GAO studies has been acknowledged by the Department of Labor on several occasions but there is no tangible evidence that the situation has been improved to any significant degree.

2. The GAO classified wage determinations as "inappropriate" if they were clearly higher than would have been the case if the secretary of labor's directive on the appropriate procedures for making wage determinations had been followed (see, for example, Table 5). Thus, it is important to emphasize that the determinations deemed "appropriate" by the General Accounting Office are themselves likely to be well above rates that would obtain under competitive bidding.

3. Both the GAO studies and a larger sampling study by Professor Gujarati show that an overwhelming fraction of the prevailing wage determinations carry union wage scales irrespective of the location or type of construction. Data on the extent of unionization in the construction industry are incomplete but it is clear that the fraction of determinations carrying union scale wages is well above the fraction of unionized workers in the building trades.

4. Professor Gujarati's study and the GAO reports indicate that a large fraction of the prevailing wage determinations carried union rates from noncontiguous counties. It is not uncommon for union contractors to obtain government construction contracts in nonunion localities, thereby excluding local contractors and often local workers from these jobs. This behavior is almost precisely the opposite of the intention of the initial act which was to prevent the federal government from either raising or lowering wages in the area of federal construction.

5. The GAO reports noted a number of instances in which similar kinds of construction projects were classified differently in making prevailing wage determinations. This inconsistency means that essentially similar projects may be classified as residential construction in one instance and commercial construction in another instance, even though the commercial construction carries substantially higher wage scales.

6. GAO also found that on-site survey data and other kinds of local wage data were ignored in making prevailing wage determinations on several construction projects which were investigated. Moreover, it was found that past prevailing wage determinations data were used to make new determinations and the inclusion of these earlier determinations substantially raised the average wage rate.

7. Since the passage of the Davis-Bacon Act in 1931, a large number of other laws have been passed which contain prevailing wage clauses. These clauses may defeat the purpose of the primary legislation in some instances. Professor Brozen points out a specific case in which an attempt to build low income housing using an interest rate subsidy was aborted because the prevailing wage clause of the National Housing Act (under which the subsidy was granted) raised construction wages so much that the benefit of the interest rate subsidy was completely washed out.

8. By creating artificial wage differentials, the Davis-Bacon Act tends to cause greater frictional unemployment in the construction trades. Construction workers appear willing to forego current employment in order to wait for jobs paying higher union wage rates. Thus in the last two years we have had the curious combination of an excessive demand for new housing and a substantial unemployment rate among construction workers.

9. High prevailing wage determinations appear, in some cases, to discourage nonunion contractors from bidding on federal construction jobs as noted on page 14. This means that nonunion contractors are less competitive, that the government has to pay a premium price for construction work, and that the bargaining power of unionized construction workers is strengthened substantially. Excluding nonunion contractors from a substantial part of the construction market also has undesirable economic consequences for minority groups and younger workers who are more likely to find employment in the nonunion sector of the construction industry.

10. Professor Brozen also argues in his paper that apprenticeship rates determined by Davis-Bacon procedures are so high that they discourage the use of apprentices on government construction work. This works counter to the government's efforts to increase the number of construction workers through manpower training programs.

11. Prevailing wage determination in general (and the practice of basing new determinations on old ones in particular) tends to freeze wage differentials that may be caused by shifts in demand. This interferes with the workings of the resource allocation mechanism and may prevent the proper flow of workers among labor markets.

12. Prevailing wage laws appear to raise the relative average wages in the construction trades as seen in the Ehrenberg, Kosters, and Moskow statistical analysis and in the rough empirical implementation of the model developed in the appendix. This analysis suggests that government construction expenditures under Davis-Bacon prevailing wage determinations may be an engine of inflation especially in periods when the amount of government construction is increasing.

Whatever the merits perceived by the framers of the Davis-Bacon Act, it appears that this legislation has had undesirable consequences for almost everyone except, perhaps, unionized construction labor. In 1970, wage increases for 3 million unionized workers in the construction industry averaged 15 to 18 percent. It is hard to understand the justification for providing the advantages of prevailing wage legislation in these circumstances. Indeed, the President suspended the Davis-Bacon Act from February 23, 1971 to March 29, 1971. One apparent reaction of organized construction labor to this suspension was to agree to a program of voluntary wage constraint which would keep increases in negotiated wages to an annual rate of about 6 percent.<sup>1</sup> The reaction of the unions is interesting because it is a piece of evidence which strongly substantiates many of the findings of this survey. It appears that the unions were willing to accept the quasi-regulated wage constraints, which they previously had rejected, in return for the reinstatement of the Davis-Bacon Act. It is difficult to see, however, how the voluntary wage restraint plan can provide a very satisfactory long-run answer to the problems discussed here. The difficulties arising from the Davis-Bacon Act include the inflationary pressure that prevailing wage determinations place on construction industry wages. But there are a large number of other problems which are of equal if not greater importance. Indeed a strong case can be made for the outright repeal of prevailing wage legislation both at the federal and state level.

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<sup>1</sup> *The New York Times* of March 30, 1971 carries an article on page one which provides further details about this action. No doubt there were other influences that led the unions to agree to the program of voluntary restraints but, given the chronology of events, it is hard to escape the implication that the Davis-Bacon Act suspension played an important role.

## Appendix A

### An Algebraic Model of the Effects of Prevailing Wage Laws

This appendix provides a simple analytical device for evaluating the effect of Davis-Bacon on average construction industry wages. The model developed here highlights many of the factors that appear to be essential to an understanding of the economics of the Davis-Bacon Act and provides a formal structure within which differences of judgment and fact can be compared and examined.

The construction industry is thought of as divided into a union and a nonunion sector. The number  $u$  ( $0 \leq u \leq 1$ ) stands for the fraction of unionized construction workers and  $(1 - u)$  is the fraction of nonunion construction workers. Wage rates are represented by  $w_u$  and  $w_c$  for union and nonunion workers respectively. From such information the average construction industry wage rate,  $A_0$ , may be calculated as follows:

$$A_0 = u w_u + (1 - u) w_c . \quad (1)$$

If the government shifts a fraction of construction contracts,  $g$ , from the union to the nonunion sector, the average wage becomes

$$A_1 = (u - g) w_u + [(1 - u) + g] w_c . \quad (2)$$

The difference in average wages attributable to the fraction  $g$  of government contracts that go to the union sector is therefore,

$$A_0 - A_1 = g(w_u - w_c) . \quad (3)$$

This difference will be positive (i.e., average wages are increased by government spending in the union sector), if the union rate,  $w_u$ , exceeds the nonunion rate  $w_c$ . The difference can be expressed in percentage terms as follows:

$$\frac{A_0 - A_1}{A_1} = \frac{g(r - 1)}{1 + (u - g)(r - 1)} \quad (4)$$

where  $r = \frac{w_u}{w_c}$ , the ratio of union to nonunion wages.

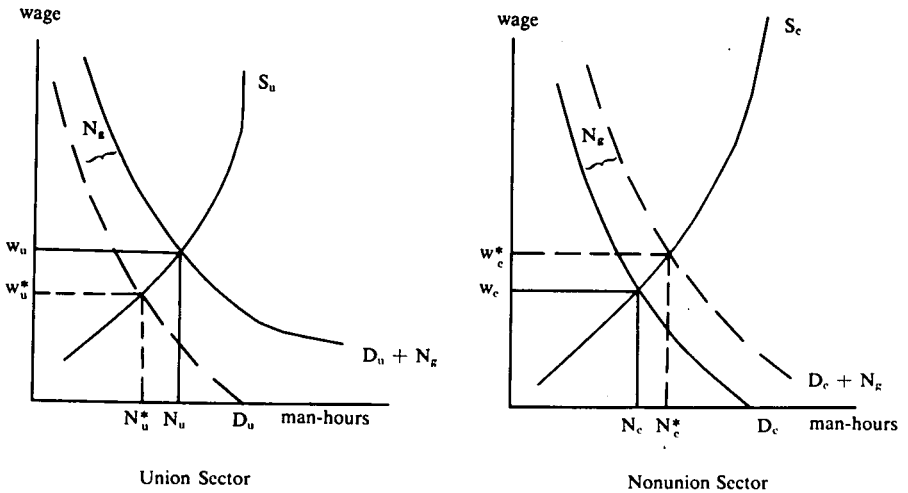
Inspection of equation (4) shows that the percentage increase in average construction industry wages attributable to government spending in the union sector will be larger, the larger the fraction  $g$  and the larger the ratio of union to nonunion wages  $r$ .

This kind of straightforward calculation glosses over several significant problems. It assumes that supply is completely elastic in the nonunion sector and that wages will be maintained in the union sector despite the loss in government demand.

If one believes that the shift in government demand automatically shifts the corresponding number of workers from the union to the nonunion sector, these assumptions are justified. However, while some shifting of this nature will no doubt occur it seems unlikely that shifts in labor supply will follow government demand on a one for one basis. There are several reasons for this. First, union workers may be willing to accept some unemployment rather than a cut in wages. Moreover, it is possible that there will be some reduction in union wages to stimulate private demand in the union sector which will partially offset the loss of government demand. It is also possible that the shift in government demand from union to nonunion labor is accompanied to some extent by "geographical" shifts in demand. Such a geographical shift need not occur because the government changes the location of its construction activities. It may occur because union labor which formerly was imported into a nonunion region would no longer be imported because such importations look less attractive at the lower nonunion wage rates.

If union labor does not shift fully into the nonunion sector following the shift in government purchases, the above measure of the change in average wages, equation (4), must be modified to allow for the accompanying changes in relative wages and employment in the union and nonunion sectors. To account for such changes, it is desirable to derive a rather general measure of the effect of government spending on average wage rates which then can be used to examine specific cases of interest.

The government's demand for construction projects is assumed to be completely price inelastic. While budget constraints and the use of cost-benefit analysis in government planning means that this assumption is not literally true, it is likely to be a very good approximation for the questions examined in this paper. Given that government contracts are price inelastic, the effect of a shift in the contracts from the union to the nonunion sector is illustrated in the following diagrams.



Initially, there are  $N_u$  man-hours (including government demand) in the union sector and  $N_c$  man-hours in the nonunion sector. The demand curves  $D_u$  and  $D_c$  represent nongovernment demand in each sector. The variables  $w_u$  and  $w_c$  are the initial wages which are determined by the intersection of the demand curves (including government demand) with their respective supply curves  $S_u$  and  $S_c$ . The inelastic demand of the government for  $N_g$  man-hours is shown initially as a horizontal shift of the union sector demand curve. If the government shifts its demand to the nonunion sector, the union sector demand curve moves to the left and the nonunion demand curve to the right thereby establishing new equilibrium wages  $w_u^*$  and  $w_c^*$  (where  $w_u^* < w_u$  and  $w_c^* > w_c$ ) and new equilibrium man-hours  $N_u^*$  and  $N_c^*$  (where  $N_u^* < N_u$  and  $N_c^* > N_c$ ).

It is interesting to see how the inelastic demand of the government in a sector serves to raise wages for nongovernmental demand in that sector. It is because of this phenomenon that unions are able to use government contracts as a device to raise wages on *nongovernment* contracts. Thus, it can be seen how Davis-Bacon determinations "spill over" to the private sector. Of course, there is also "spillover" to private construction in the nonunion sector when government contracts are moved there. The following analysis will be helpful in unscrambling and comparing these effects.

Before going to the analysis of the above shift we consider the general problem of the effect on wages and employment of a change in price inelastic demand in a market. In equilibrium, these conditions obtain

$$q_d = I + f(p) \quad (5)$$

$$q_s = s(p) \quad (6)$$

$$q_s = q_d = q_m \quad (7)$$

Condition (5) is the market demand—I represents the inelastic demand and  $f(p)$  the price dependent demand. Condition (6) is market supply and condition (7) establishes the market clearing quantity and, hence, price. Condition (7) can be used to eliminate  $q_d$  and  $q_s$  from (5) and (6) so that

$$I + f(p) = s(p). \quad (8)$$

Differentiating (8) with respect to  $I$  we obtain

$$1 + f'(p) \frac{dp}{dI} = s'(p) \frac{dp}{dI}.$$

Rearranging,

$$dp = \frac{dI}{s'(p) - f'(p)}.$$

Multiplying both sides by  $1/p$  and multiplying the right-hand side by  $(1/q_c)/(1/q_c) = 1$

$$\frac{dp}{p} = \frac{dI/q_c}{\eta_s - \eta_d} \quad (9)$$



where  $\eta_s$  and  $\eta_d$  are respectively the supply and demand price elasticities.<sup>1</sup> Thus, equation (9) says that the percentage change in price is equal to the increase in inelastic demand as a percent of the initial equilibrium quantity divided by the difference between supply elasticity and demand elasticity. Since the elasticities are calculated at the initial equilibrium, this equation is an approximation that is equivalent to assuming linear supply and demand curves over the range of the shift. The percentage change in the equilibrium quantity is then

$$\frac{d_q}{q_e} = \frac{dI}{q_e} \left( 1 + \frac{\eta_d}{\eta_s - \eta_d} \right). \quad (10)$$

Equations (9) and (10) can be used to evaluate the shifts illustrated in the above diagrams. Before the government shifts its demand to the nonunion sector, the average construction industry wage is

$$A_0 = \frac{w_u N_u + w_c N_c}{N_u + N_c} = u w_u + c w_c$$

where  $u$  is the fraction of man-hours in the union sector and  $c = 1 - u$  is the fraction of man-hours in the nonunion sector. Now let  $\dot{\Delta} w_c$  and  $\dot{\Delta} w_u$  be the percentage change in nonunion and union wage rates respectively. Then using (9) and (10), the new equilibrium values of wages and employment in each sector can be written

$$w_c^* = w_c (1 + \dot{\Delta} w_c) = w_c \left( 1 + \frac{N_g}{N_c} \frac{1}{\eta_s^c - \eta_d^c} \right) \quad (11)$$

$$N_c^* = N_c (1 + \eta_d^c \dot{\Delta} w_c) + N_g = N_c \left[ 1 + \left( \frac{N_g}{N_c} \right) \frac{\eta_d^c}{\eta_s^c - \eta_d^c} \right] + N_g \quad (12)$$

$$w_u^* = w_u (1 + \dot{\Delta} w_u) = w_u \left( 1 - \left( \frac{N_g}{N_u - N_g} \right) \frac{1}{\eta_s^u - \eta_d^u} \right) \quad (13)$$

$$N_u^* = (N_u - N_g) (1 + \eta_d^u \dot{\Delta} w_u) = (N_u - N_g) \left( 1 - \left( \frac{N_g}{N_u - N_g} \right) \frac{\eta_d^u}{\eta_s^u - \eta_d^u} \right) \quad (14)$$

where  $\eta_s^c$ ,  $\eta_d^c$  are the supply and demand elasticities in the nonunion sector and  $\eta_s^u$ ,  $\eta_d^u$  are the supply and demand elasticities in the union sector. Following the shift in government demand, the average wage rate becomes

$$A_1 = \frac{w_c^* N_c^* + w_u^* N_u^*}{N_c^* + N_u^*}. \quad (15)$$

<sup>1</sup> Demand elasticity is the percentage change in quantity demanded divided by the percentage change in price. The supply elasticity is the percentage change in quantity supplied divided by the percentage change in price.

Using equations (11), (12), (13) and (14) and dividing through by  $N_u$ , (15) may be expressed in terms of the initial proportions as:

$$A_1 = \frac{w_c \left[ 1 + \frac{g}{c} \lambda_c \right] \left[ 1 + \frac{g}{c} (1 + \eta_u^s \lambda_u) \right] + w_u \left( \frac{u-g}{c} \right) \left( 1 - \frac{g}{u-g} \lambda_c \right) \left( 1 - \frac{g}{u-g} \frac{1}{\eta_u^s} \lambda_u \right)}{\left[ 1 + \frac{g}{c} (1 + \eta_u^s \lambda_u) \right] + \frac{u-g}{c} \left( 1 - \frac{g}{u-g} \lambda_u \eta_u^s \right)} \quad (16)$$

where  $\lambda_c = \frac{1}{\eta_s^c - \eta_d^c}$  and  $\lambda_u = \frac{1}{\eta_s^u - \eta_d^u}$ .

It is possible to derive specific cases from this general expression. For example, equation (2) is equivalent to the assumption that both supply elasticities are infinite (completely elastic) since union labor shifts freely into the nonunion sector. This means that  $\lambda_u$  and  $\lambda_c$  are zero and (16) becomes

$$A_1 = \frac{w_c \left( 1 + \frac{g}{c} \right) + w_u \left( \frac{u-g}{c} \right)}{1 + \frac{g}{c} + \frac{u-g}{c}} = w_c(c+g) + w_u(u-g). \quad (17)$$

Since  $c = 1 - u$ , this is the same expression as (2). At another extreme, one might assume that the union accepts whatever wage cut is necessary to maintain union employment at the pre-shift level  $N_u$ . In this case,  $\eta_s^u = 0$  so  $\lambda_u = -1/\eta_d^u$  and (16) becomes

$$A_1 = \frac{w_c \left[ 1 + \frac{g}{c} \lambda_c \right] \left[ 1 + \frac{g}{c} (1 + \eta_u^s \lambda_u) \right] + w_u \left( 1 + \frac{g}{u-g} \right) \left( \frac{u-g}{c} \right) \left[ 1 + \frac{g}{u-g} \frac{1}{\eta_u^s} \right]}{\left[ 1 + \frac{g}{c} (1 + \eta_u^s \lambda_u) \right] + \frac{u-g}{c} \left( 1 + \frac{g}{u-g} \right)} \quad (18)$$

Equation (18) is more complex than (17) because there are changes in nonunion employment (and hence total employment in construction) and because there are wage changes in both sectors. One must use some caution with (18) because if it is interpreted in a strictly mechanical manner it would be possible in some cases to have the union wage rate drop below the nonunion rate. Since this is nonsense from an economic point of view it would be necessary to drop the assumption of complete inelasticity of union supply if it implies a "negative" differential in the empirical estimates.

This raises another, more realistic, question, however. One might wish to think of the union supply curve as a function of the *difference* in union and non-union wage rates, as well as the union rate itself. No attempt is made here to build this possibility into a formal model but it is worth keeping this idea in mind when interpreting the results of equation (18). In particular, if the differential between union and nonunion rates gets very small, it is probably best to drop the assumption of complete inelasticity of supply.

A major advantage of equation (18) is to focus attention on economic variables that play a key role in determining the effect of the Davis-Bacon Act. It is

very difficult to get any good data on the parameters—we need to have values for four elasticities; the proportion of man-hours in union, government, and nonunion construction work; and the differential between union and nonunion wages, the theoretical and empirical questions involved are noted on page 23 of the text.

## Appendix B

### The Ehrenberg, Kosters and Moskow Analysis

This appendix briefly summarizes the preliminary work by Ehrenberg, Kosters, and Moskow to estimate the effect of Davis-Bacon type contracts on the relative wages of construction workers. The basic statistical model they examined is <sup>1</sup>

$$R = a_0 + a_1 U + a_2 \text{ PUB} + a_3 G.$$

R is a measure of the relative wage of unionized construction workers, U is the extent of unionization in nonresidential construction, PUB is the proportion of nonresidential construction that is publicly financed or assisted and G is a measure of recent growth in construction activity. All of these variables are logarithms of the basic data.

The coefficients  $a_1$ ,  $a_2$ ,  $a_3$ —measuring the relationship of U, PUB, and G to relative union wages R—are unknown and must be estimated. For example, if  $a_2$  is found to be positive it implies that increases in the proportion of nonresidential construction that is publically financed increase union wage rates relative to other wages.

It is difficult to get precise data on the relevant variables in this equation and the authors provide a detailed discussion of the conceptual difficulties inherent in the measures they used. The reader who is interested in a detailed discussion of these problems is referred to the Ehrenberg-Kosters-Moskow paper. We provide a brief description of the data here.

The data for all variables were obtained from a cross-section of 62 metropolitan areas with populations of over 100,000. The authors used three measures of relative union wage rates, but we will focus on only one of them here. The variable R is the average union wage scale of journeymen in the building trades divided by the average hourly earnings of local production workers in manufacturing.<sup>2</sup> These wage data were obtained from Bureau of Labor Statistics publications and were averaged over a three year period (1967, 1968, and 1969) in an attempt to avoid the effects of different timings of contract expirations over the 62 metropolitan areas. The geographical coverage of the two wage series is not identical (city vs. Standard Metropolitan Statistical Area).

<sup>1</sup> Ronald G. Ehrenberg, "The Economic Impact of Davis-Bacon Type Legislation: An Econometric Study," unpublished paper, March 1971.

<sup>2</sup> The authors also used (a) the ratio of building trade helpers average union wage scales to average hourly earnings of manufacturing production workers, and (b) the ratio of building trade helpers average union wage scales to journeymen average union wage scales in other regressions.

The measure of unionization in each area,  $U$ , is the ratio of building trade union membership in each area to average nonresidential construction employment in the SMSA. Details on the construction of this variable can be found in the Ehrenberg-Kosters-Moskow paper.  $PUB$  is the proportion of the value of non-residential construction in the SMSA which appeared to be either publicly financed or assisted. This variable is obtained from unpublished data of the F. W. Dodge Company on the value of construction contract awards by city and type of construction. The variable is defined to include construction activity defined as public by F. W. Dodge and transportation-related building (such as airplane hangars) and also utilities and transportation-related nonbuilding construction. The authors believe that the bulk of these additional construction activities are covered by legislation that contains Davis-Bacon type prevailing wage determination clauses. In order to get a measure of the "permanent" impact of Davis-Bacon determinations, these data were averaged over the three year period 1965-67.

$G$  is the growth of construction in the area and is measured as the percentage change of the average value of construction in 1965-67 over the average value of construction in 1961-64.

Using standard statistical regression techniques, the authors estimated several equations. The following equation is a typical example of the results,<sup>3</sup>

$$R = 2.184 + .678 \text{ PUB} + .121 \text{ U} + .243 \text{ G}.$$

This equation may be interpreted as follows: When the proportion of publicly financed construction in an area (i.e.,  $PUB$ ) rises by 10 percent, union wages of journeymen in construction rise by about 6.8 percent relative to wages of production workers in manufacturing.<sup>4</sup> The effect of increases in the fraction of publicly financed construction appears to be stronger than the effect of increases in construction activity—a 10 percent increase in  $G$  raises relative union wages of journeymen in the building trades by about 2.4 percent.

Among the other regressions reported by Ehrenberg, Kosters, and Moskow is the following,<sup>5</sup>

$$RW3 = -.182 + .118 \text{ PUB} + .002 \text{ U} + .065 \text{ G},$$

where  $RW3$  is the ratio of building trade helpers' average union wage scales to building trade journeymen in each area. The coefficient on  $PUB$  in this equation, .118, indicates that a 10 percent increase in the fraction of publicly financed or assisted construction raises the average wages of helpers by about 1.2 percent relative to journeymen in the building trades. This increase probably results from the tendency of Davis-Bacon determinations to set very high relative wage rates

<sup>3</sup> The t-ratios are 5.01, 2.44, 1.19, and 2.52 for the constant,  $PUB$ ,  $U$ , and  $G$  respectively. The squared multiple correlation coefficient is .259. The authors' other regressions provided generally similar kinds of results.

<sup>4</sup> The coefficients of  $PUB$ ,  $U$ , and  $G$  are elasticities, since all variables are measured in logarithms.

<sup>5</sup> The t-ratios are 1.78, 1.78, .06 and 2.83 for the constant term,  $PUB$ ,  $U$  and  $G$ , respectively. The squared coefficient of multiple correlation is .195.

for workers in apprenticeship training programs as was noted by Professor Brozen in the paper mentioned earlier.<sup>6</sup>

The preliminary findings of Ehrenberg, Koster, and Moskowitz have to be interpreted with some caution. The authors note that their estimates are only tentative given the crude nature of the data and the limited geographic coverage of the sample. They also point out that there is no presumption that their model contains all the relevant variables. Indeed, the squared multiple correlation coefficients of between .2 and .4 suggest that additional explanatory variables might successfully be incorporated into the model.

It is not easy to ascertain the precise impact of Davis-Bacon determinations from these results, since it is possible that increases in public construction *per se* (i.e., in the absence of prevailing wage determinations) may lead to somewhat similar results. This problem is handled in part by the use of the control variable G, but there is some danger of multicollinearity between PUB and G (and also PUB and U). There is also the danger, as the authors point out, that any "spillover" of wages in construction to wages in other industries (such as manufacturing) can result in a downward bias in the estimate of the *relative* impact of PUB, U, and G.

Despite such ambiguities, these initial findings are in accordance with the studies of the General Accounting Office and the work of Professor Gujarati and the accumulated evidence points quite strongly in the direction that Davis-Bacon determinations (and determinations of related legislation) exert a powerful upward pressure on relative wages in the construction industry. This upward movement appears to take place directly in public construction and indirectly in private construction through the increased bargaining power which unions derive from the prevailing wage laws.

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<sup>6</sup> Yale Brozen, "The Davis-Bacon Act: How to Load the Dice Against Yourself," *op. cit.*

**Appendix C**  
**Davis-Bacon Act (as amended)**

**40 U.S. CODE, § 276**

**a. Rate of wages for laborers and mechanics**

(a) The advertised specifications for every contract in excess of \$2,000, to which the United States or the District of Columbia is a party, for construction, alteration, and/or repair, including painting and decorating, of public buildings or public works of the United States or the District of Columbia within the geographical limits of the States of the Union, or the District of Columbia, and which requires or involves the employment of mechanics and/or laborers shall contain a provision stating the minimum wages to be paid various classes of laborers and mechanics which shall be based upon the wages that will be determined by the Secretary of Labor to be prevailing for the corresponding classes of laborers and mechanics employed on projects of a character similar to the contract work in the city, town, village, or other civil subdivision of the State, in which the work is to be performed, or in the District of Columbia if the work is to be performed there; and every contract based upon these specifications shall contain a stipulation that the contractor or his subcontractor shall pay all mechanics and laborers employed directly upon the site of the work, unconditionally and not less often than once a week, and without subsequent deduction or rebate on any account, the full amounts accrued at time of payment, computed at wage rates not less than those stated in the advertised specifications, regardless of any contractual relationship which may be alleged to exist between the contractor or subcontractor and such laborers and mechanics, and that the scale of wages to be paid shall be posted by the contractor in a prominent and easily accessible place at the site of the work; and the further stipulation that there may be withheld from the contractor so much of accrued payments as may be considered necessary by the contracting officer to pay to laborers and mechanics employed by the contractor or any subcontractor on the work the difference between the rates of wages required by the contract to be paid laborers and mechanics on the work and the rates of wages received by such laborers and mechanics and not refunded to the contractor, subcontractors, or their agents.

(b) As used in sections 276a to 276a-5 of this title the term "wages", "scale of wages", "wage rates", "minimum wages", and "prevailing wages" shall include—

- (1) the basic hourly rate of pay; and

(2) the amount of—

(A) the rate of contribution irrevocably made by a contractor or subcontractor to a trustee or to a third person pursuant to a fund, plan, or program; and

(B) the rate of costs to the contractor or subcontractor which may be reasonably anticipated in providing benefits to laborers and mechanics pursuant to an enforceable commitment to carry out a financially responsible plan or program which was communicated in writing to the laborers and mechanics affected,

for medical or hospital care, pensions on retirement or death, compensation for injuries or illness resulting from occupational activity, or insurance to provide any of the foregoing, for unemployment benefits, life insurance, disability and sickness insurance, or accident insurance, for vacation and holiday pay, for defraying costs of apprenticeship or other similar programs, or for other bona fide fringe benefits, but only where the contractor or subcontractor is not required by other Federal, State, or local law to provide any of such benefits:

*Provided*, That the obligation of a contractor or subcontractor to make payment in accordance with the prevailing wage determinations of the Secretary of Labor, insofar as sections 276a to 276a-5 of this title and other Acts incorporating sections 276a to 276a-5 of this title by reference are concerned may be discharged by the making of payments in cash, by the making of contributions of a type referred to in paragraph (2) (A), or by the assumption of an enforceable commitment to bear the costs of a plan or program of a type referred to in paragraph (2) (B), or any combination thereof, where the aggregate of any such payments, contributions, and costs is not less than the rate of pay described in paragraph (1) plus the amount referred to in paragraph (2).

In determining the overtime pay to which the laborer or mechanic is entitled under any Federal law, his regular or basic hourly rate of pay (or other alternative rate upon which premium rate of overtime compensation is computed) shall be deemed to be the rate computed under paragraph (1), except that where the amount of payments, contributions, or costs incurred with respect to him exceeds the prevailing wage applicable to him under sections 276a to 276a-5 of this title, such regular or basic hourly rate of pay (or such other alternative rate) shall be arrived at by deducting from the amount of payments, contributions, or costs actually incurred with respect to him, the amount of contributions or costs of the types described in paragraph (2) actually incurred with respect to him, or the amount determined under paragraph (2) but not actually paid, whichever amount is the greater.

**a-1. Termination of work on failure to pay agreed wages; completion of work by Government**

Every contract within the scope of sections 276a to 276a-5 of this title shall contain the further provision that in the event it is found by the contracting officer



that any laborer or mechanic employed by the contractor or any subcontractor directly on the site of the work covered by the contract has been or is being paid a rate of wages less than the rate of wages required by the contract to be paid as aforesaid, the Government may, by written notice to the contractor, terminate his right to proceed with the work or such part of the work as to which there has been a failure to pay said required wages and to prosecute the work to completion by contract or otherwise, and the contractor and his sureties shall be liable to the Government for any excess costs occasioned the Government thereby.

**a-2. Payment of wages by Comptroller General from withheld payments; listing contractors violating contracts**

(a) The Comptroller General of the United States is authorized and directed to pay directly to laborers and mechanics from any accrued payments withheld under the terms of the contract any wages found to be due laborers and mechanics pursuant to sections 276a to 276a-5 of this title; and the Comptroller General of the United States is further authorized and is directed to distribute a list to all departments of the Government giving the names of persons or firms whom he has found to have disregarded their obligations to employees and subcontractors. No contract shall be awarded to the persons or firms appearing on this list or to any firm, corporation, partnership, or association in which such persons or firms have an interest until three years have elapsed from the date of publication of the list containing the names of such persons or firms.

(b) If the accrued payments withheld under the terms of the contract, as aforesaid, are insufficient to reimburse all the laborers and mechanics, with respect to whom there has been a failure to pay the wages required pursuant to sections 276a to 276a-5 of this title, such laborers and mechanics shall have the right of action and/or of intervention against the contractor and his sureties conferred by law upon persons furnishing labor or materials, and in such proceedings it shall be no defense that such laborers and mechanics accepted or agreed to accept less than the required rate of wages or voluntarily made refunds.

**a-3. Effect on other Federal laws**

Sections 276a to 276a-5 of this title shall not be construed to supersede or impair any authority otherwise granted by Federal law to provide for the establishment of specific wage rates.

**a-4. Effective date of sections 276a to 276a-5**

Sections 276a to 276a-5 of this title shall take effect thirty days after August 30, 1935, but shall not affect any contract then existing or any contract that may thereafter be entered into pursuant to invitations for bids that are outstanding on August 30, 1935.

**a-5. Suspension of sections 276a to 276a-5 during emergency**

In the event of a national emergency the President is authorized to suspend the provisions of sections 276a to 276a-5 of this title.

**a-6. Appropriation****a-7. Application of sections 276a to 276a-5 to contracts entered into without regard to section 5 of Title 41**

The fact that any contract authorized by any Act is entered into without regard to section 5 of Title 41, or upon a cost-plus-a-fixed-fee basis or otherwise without advertising for proposals, shall not be construed to render inapplicable the provisions of sections 276a to 276a-5 of this title, if such Act would otherwise be applicable to such contract.

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Chairman PROXMIRE. Now, the cost of various Federal guarantees and insurance programs, as well as loans made by federally sponsored agencies, no doubt raise the Treasury cost of borrowing to some extent.

Can you, as the economic policy expert for the Treasury until recently, can you give us, the subcommittee, any estimate of these costs of the guarantee and insurance programs, the effect that has on the cost of Treasury borrowing?

Mr. WEIDENBAUM. To my knowledge, such estimates have not been made. I don't expect they would be of the heroic proportions of the \$5 to \$6 billion.

Chairman PROXMIRE. I am talking about loans made by federally sponsored agencies, too.

Mr. WEIDENBAUM. Well, I have tried to estimate in my testimony the subsidies, except for that one element of the agency issues, the fact that Fanny Mae and the other farm credit agencies can issue securities in the private market not only at lower interest rates than would be the case but also by increasing the total volume of Government-related issuances, they inevitably must have an upward impact on the level of interest rates that the Treasury pays, I can't measure it.

Chairman PROXMIRE. If you can suggest what that is and how we get it. Once again, if we get a figure, many of us, our minds work in an arithmetic way, if we know what it is then we can begin to focus some attention on it and get some interest and then begin to consider it much more critically and effectively, rather than just to say there is an effect.

Mr. WEIDENBAUM. I know they are overburdened and all that but I might suggest your asking the Treasury Department.

Chairman PROXMIRE. Good, fine; we will be happy to say it was a recommendation by one of their former beloved colleagues.

Mr. Weidenbaum, your third recommendation is that credit programs be reviewed and coordinated along with other Federal programs in the preparation of the Government's annual budget and economic plans.

Would you please give the subcommittee your full recommendations on how both credit and tax subsidies ought to be handled in the budget?

Mr. WEIDENBAUM. One way is the kind of analysis I presented to this committee in June of 1970. Via a comprehensive governmentwide program budget, the capstone would be a summary table where down the side you have the different purposes and functions of government and across you have the different categories of financing—direct budget expenditures, tax incentives, loan subsidies, and so forth. Thus, the executive branch, the legislative branch and the public, could see how for any given government function what the total volume of governmental activity is, not what just is in the budget, say, for housing but what is in the budget plus what is in the tax incentives and in the credit programs for housing. It was an eye opener to me when I did this.

Why? Because the implied priorities change.

Let's take that one of housing. If you rank the various Government programs by their shares of the budget, housing looks like it is small potatoes; it is way down the list. But if you add in the tax benefits and the credit programs, and then rank programs by their share of the budget, the position of housing goes way up.

Conversely, the positions of health and education decline a bit and I think we get a better picture of what the priority positions of public programs really are.

Chairman PROXMIRE. I think that is a good observation. It makes a lot of sense. I would like to ask you, finally, about the value-added tax. There has been a lot of discussion about that and I can't think the administration is not thinking very highly of it in view of the trial balloons they have been floating. I have announced this committee is going to hold hearings not on the revenue aspects, that is, for the tax writing committees, but on the social and economic implications that could change our system to some extent. My own view is a biased view; I want to tell you I am against it. It is a hidden, regressive tax; I don't want to see it enacted.

All of our previous witnesses in this set of hearings have either opposed such a tax altogether or accepted it only as a last choice. They say there are other tax priorities such as strengthening the income tax and so forth.

The previous witnesses supported reform of the individual and corporate income tax, eliminating inefficient and inequitable tax subsidies, as a much better way to obtain additional revenue.

What is your recommendation to the subcommittee on the value-added tax and tax reform?

Mr. WEIDENBAUM. First of all, I am not sure this is pertinent but on a Christmas card to one of my former colleagues in the Treasury I added a little note: "May your value be added but not taxed."

I am not sure what the reaction was.

Chairman PROXMIRE. I think it is a good card. [Laughter.]

Mr. WEIDENBAUM. I have had occasion to weigh the pros and cons of the value-added tax and let me say that there are important elements on both parts of the scale. First of all, you call the value-added tax regressive. To use an old refrain, "it ain't necessarily so." I have seen versions of value-added tax proposals which eliminate the regressivity. They don't make it a progressive tax, let's frankly admit, but they do eliminate or reduce the regressivity either by exemptions or more likely by offsets on the Federal income tax form so they do deal with that point.

Chairman PROXMIRE. That is pretty hard to do by the latter. After all, so many of low-income people don't pay any income tax because they don't have taxable income or they pay very little to offset—

Mr. WEIDENBAUM. But they can get a refund.

Chairman PROXMIRE. Refund; you mean get money in addition to what they paid in?

Mr. WEIDENBAUM. Yes; some States do that.

Chairman PROXMIRE. Yes; we do that in Wisconsin. We do it in our sales tax. It is a tax I have always fought. It is a serious mistake but as you say, it can be made less regressive; undoubtedly true.

Mr. WEIDENBAUM. As to its being a hidden tax, it would operate similarly to sales taxes, I presume, to the extent that, certainly from the manufacturer, wholesaler, retailer, in that chain, the amount of value-added tax would be made crystal clear.

Chairman PROXMIRE. Yes; but, you see, the point I make and many of the taxpayer groups make is that it is hidden in the sense it is not added at the retail level where the typical consumer can see it, by and

large. "Here are 3 cents for the Governor," as they always say in our State.

Mr. WEIDENBAUM. It could be. There is nothing to prevent it.

Chairman PROXMIRE. For one thing, only the last increment would be added; pretty hard for the retailer to figure out what that value-added tax amounted to.

Mr. WEIDENBAUM. It depends on how you formulate it. One way of formulating the value-added tax, as I understand it, is to show the gross at each stage and this is part of the built-in enforcement of it—at each stage compute the tax on the total sales and deduct from that the value-added taxes paid earlier in the production process. This does two things: One, of course, the retailer or wholesaler in each case only would pay the net. But to the extent that there is underpayment of value-added tax at an earlier stage in the production process, he would pay that much more. So in each stage of the process the company has a strong incentive to make sure that the proper payment was made by the earlier stages of the process. Otherwise he will overpay his value-added tax.

So thus you would know the total amount of the value-added tax.

Chairman PROXMIRE. So far what you have told us, while it is regressive it can be made a little less regressive; while it is hidden it can be made visible under a certain version.

What are benefits of this tax?

Mr. WEIDENBAUM. It is a tax essentially on the use of resources, on consumption; hence it would be an added spur to investment and hence economic growth and employment.

Chairman PROXMIRE. How many incentives do we have to give to investment? We have investment credit, capital gains benefits; we have all these others. Does this just go on endlessly?

Mr. WEIDENBAUM. That is not the way I see it, Mr. Chairman. The comparison I have seen of the United States and, say, Western European tax systems indicate that they rely more heavily on indirect taxes such as value-added, sales, consumption-type taxes than we do and, hence, they give greater incentives to investment than we do.

Chairman PROXMIRE. It is my understanding that the income tax is gradually declining in importance as a revenue-producing factor; the sales tax is second. We had evidence that the—talking about the corporate income tax—the corporate income tax may go down to fourth, be replaced by the property tax. At any rate—

Mr. WEIDENBAUM. There is something about the individual income tax that makes it a stronger tax than we tend to realize. There have been studies that show that, because of the increase in incomes and in prices, without any change in rate, the effective tax rate of an individual goes up over time.

Chairman PROXMIRE. That's right. If we had maintained the act we had in, say, 1963 or 1964 we would be, on the assumption you have the same degree of economic activity it would be yielding a great deal but we have reduced it, haven't we?

Mr. WEIDENBAUM. The rate reductions by and large over the post-war period have been offset by this upward drift in real incomes; hence I am not prepared to say that the average effective real rate is any lower than it was 10 or 20 years ago.

Representative BLACKBURN. I just want to ask a couple of short questions here.

You were talking about the justification for some of our tax programs such as the capital gains tax and you have to consider the alternatives that might be necessary.

Now, a thought comes to mind regarding the deductibility of interest in our home mortgages. The proposition was proposed last week that we eliminate that interest deductibility and subsidize the homeowner.

Now, what is your thought about the creation of a new bureaucracy to manage this fund as an alternative to the allowing the deductibility of our interest?

Mr. WEIDENBAUM. I would be very concerned about that recommendation, Mr. Blackburn. I have had occasion recently to study the deterioration of the housing stock of the city of St. Louis and—

Representative BLACKBURN. You are familiar with it?

Mr. WEIDENBAUM. It is not a unique situation. In fact, it is typical of large cities. One of the ways of halting the growing blight of our cities, I believe, is to foster homeownership, to encourage the individual family to have a stake in its housing. Hence, I would be very reluctant to support at this time, reducing, much less eliminating, the present tax treatment of homeownership.

Representative BLACKBURN. Let me ask you this one last question:

Is it possible for the Productivity Commission to stop this effect of Government-induced inflation where we all become kissing cousins?

Mr. WEIDENBAUM. Well, there are two points here: First of all there is John Maynard Keynes, the man who made fundamental contributions to the way economists analyze the economy and I have been able to come up with good Republican policies and recommendations using the Keynesian framework. Nevertheless, it is quite clear to me that—and I so testified before Senator Proxmire in 1967, on a very important study on the Vietnam situation, that he chaired—Government policy was the origin of the inflationary problem that faces us at the very present time.

Representative BLACKBURN. Thank you again.

Chairman PROXMIRE. Mr. Weidenbaum, once again you have been most helpful. You are one of our favorite Republicans.

Representative BLACKBURN. Probably the only one. [Laughter.]

Chairman PROXMIRE. My mother and father and brother and sister were Republicans. I trust Republicans with anything but public office.

I will say in conclusion that the Joint Economic Committee will in the first half of this year publish approximately 35 papers evaluating specific Federal subsidies. These studies will cover the following areas: agriculture, food, education, manpower, international trade, housing, natural resources, transportation, tax subsidies, and other areas as well.

The subcommittee will hold further hearings in these specific areas as these studies and other information on specific Federal subsidies become available.

Once again, thank you very much. We do appreciate so much your coming here. You have been a very fine and helpful witness.

Mr. WEIDENBAUM. Thank you very much.

Chairman PROXMIRE. We will stand adjourned.

(Whereupon, at 12:25 p.m., the subcommittee was adjourned, to reconvene subject to the call of the Chair.)