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SAVINGS AND ECONOMIC GROWTH

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SAVINGS AND ECONOMIC GROWTH

WEDNESDAY, JULY 30, 1980

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

The committee met, pursuant to notice, at 10 a.m., in room 5110, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen and Roth; and Representative Brown.

Also present: John M. Albertine, executive director; Louis C. Krauthoff II, assistant director-director, SSEC; Charles H. Bradford, minority counsel; William R. Buechner, professional staff member; and Stephen J. Entin and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. This hearing will come to order.

Gentlemen, welcome back. It was in 1977, I believe, when we had this same group on capital formation. I can't stress too strongly "I told you so," because we all agreed at that time what had to be done.

I think this is one of the most difficult eras from an economic standpoint our country has ever faced. We've got to defeat the high unemployment, high inflation syndrome that has plagued our economy for the past decade. We didn't get into this overnight. It has taken us about a decade to get into this position with inflation. Inflation was 15 percent in the first half of this year and unemployment is currently 7.7 percent. It's obviously going to take some time to get out of it, but if there's one thing that underlies the work of the Joint Economic Committee, I think it's the fact that we believe we can solve these current problems. But we don't think there's any quick fix. It's not going to be easy and it's going to take some time.

What we do offer is a long-term program, focusing on the need for more investment, better productivity, and a more efficient economy.

The United States has the lowest personal savings rate of any of the major nations. The U.S. personal savings rate averaged less than 7 percent in 1973 to 1977, while the savings rates of our leading trading partners ranged from over 10 percent in Canada to over 20 percent in Japan and Italy. Furthermore, we have seen the savings rate in the United States trending down for the last 7 years, falling to less than half its 1973 level.

This has grave implications for the rate of investment in new plant and equipment, the modernization of American factories and the productivity of American labor.

U.S. productivity has grown more slowly than that of our competitors, hampering the ability of the United States to compete in the world marketplace and to preserve jobs in basic industries such as steel and automobiles.

The productivity slump also threatens our ability to provide the goods and services we have promised under the social security system to those now retired and to the millions who will retire in the coming decades.

At this hearing we will ask the witnesses how inflation and the tax code affect an individual's motivation and ability to save, and how saving and growth are related to the future of social security. We also want to know their views of the relationship between personal saving and economic growth, as well as what tax changes or other policy steps might prove to be most cost effective in turning this situation around.

I have people sometimes bring it to our attention that we are not a legislative committee. I think that may be one of our strengths. What we have here is the power of the ideas that disinguished economists like yourselves bring to the forefront. I think it's remarkable the consensus that has begun to develop on what we have to do in the way of savings and productivity in this country. This committee has been able to play a very major role in it for some time now.

I am very pleased this morning that we have Martin J. Bailey, professor of economics, University of Maryland; Michael Boskin, professor of economics, Stanford University; Oswald Brownlee, professor of economics, University of Minnesota; Robert Eisner, professor of economics, Northwestern University; and Martin Feldstein, president, National Bureau of Economic Research, Inc., Cambridge, Mass., and professor of economics, Harvard University.

I want to reverse the order and let the last part of the group go first for a change. Mr. Feldstein.

STATEMENT OF MARTIN FELDSTEIN, PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH, INC., CAMBRIDGE, MASS., AND PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

Mr. Feldstein. Thank you, Mr. Chairman. I am very pleased to be able to participate in this hearing on the subject of tax reform to increase saving and investment.

I think what has happened in the last decade has been a dramatic change in the effective taxation of incomes and savings and this has happened not because of any legislative initiatives on the part of the Congress but because of the interaction of inflation and our existing tax laws.

Because of historical cost depreciation, FIFO inventory accounting, taxation of nominal capital gains, and the taxation of artificial interest income, the effective rate of tax has risen very, very substantially, more so I think than most people realize.

That means that the aftertax rate of return available to savers has dropped very sharply. I think you can summarize it by looking at what has happened to the effective Federal tax rate on the total capital income of corporations. When I say the effective Federal tax rate,

what I have in mind is a combination of the taxes paid by the corporations themselves, by their creditors, and by their shareholders.

If you look back to the early 1950's before any of the tax changes designed to stimulate investment were put in place, that effective tax rate was about 70 percent. The introduction of accelerated depreciation, the investment tax credit, and the reduction in some of the tax rates led to a sharp reduction in that by the early 1960's and with it came the investment boom of the 1960's. We look at the total effective tax rate in a year like 1964–65; Federal taxes took about 51 percent of total nonfinancial corporate income. The effective tax rate has grown, slowly at first and much more rapidly during the past few years. By the late 1970's the Federal Government was taking more than two-thirds instead of just one-half.

Senator BENTSEN. Are you reading from any particular place in your prepared statement?

Mr. FELDSTEIN. No; I'm not. I'm just speaking from some notes.

Senator BENTSEN. All right.

Mr. FELDSTEIN. I just wanted to emphasize these figures before I talked about tax cuts in particular because I think they really do condition the problem that Congress now has.

The most recent figures we have prepared indicated that in 1979 Federal taxes took 71 percent of pretax corporate income. That's not just the corporate tax itself, but the taxes paid by the corporations, by the shareholders, and by the creditors.

The pretax rate of return was perhaps 11 percent. The aftertax rate of return was just a little less than a third of that or about 3½ percent. State taxes take a further part of that. The combination of State taxes and Federal taxes was taking about between 55 and 60 percent of pretax profits in the mid-1960's. In 1979, that share reached 76 percent.

It's not surprising, with taxes taking nearly three-fourths of pretax profits, that the net incentive to save and invest is very, very small.

I think that the challenge for tax policy for the next several years is to reverse that trend and get us back to the kind of effective tax rates on capital income that prevailed earlier.

Unfortunately, at this time, there's also a concern—I think a correct concern—that any tax cut might simply exacerbate inflation. That's leading to a reluctance, as I have seen in hearings before the Finance Committee last week and the Ways and Means Committee on Monday—to undertake any tax cut now.

I think that's misplaced. We can afford a tax cut and we can start a tax cut now which will not be inflationary.

I think there are two solutions to this apparent conflict between the need for substantial tax cuts on the one hand and the fear of exacerbating inflation on the other.

The first of these is to start by enacting now a series of subsequent tax cuts aimed at providing substantial incentives for saving and investment. I think we can get very substantial immediate effects on savings and investment without any significant shortrun deficits. I will explain that—it's spelled out in more detail in my prepared statement—and I'd like to read some of that in a minute.

The second aspect of having a desirable tax cut without exacerbating inflation is to emphasize savings. The concern about a tax cut hav-

ing bad effects on inflation stems from two things: Government deficits and expanded private demand, either household or investment. They contribute to inflation, but an increase in savings reduces demand and makes room for both those deficits, and expanded private investment.

To the extent that the tax changes that are undertaken now increase savings—and I think that can be readily achieved without any substantial current deficits—by a precommitted series of future tax cuts. We don't have to worry about the inflationary impact of increases in investment. And I would note that that argument doesn't rely on longrun supply side effects. It's a shortrun, aggregate demand argument.

Let me read just briefly from the prepared statement and have the rest of it included in the record.

The most important thing to consider when thinking about a tax cut strategy is that all important economic decisions are based on expectations about the future. What matters for current actions—investment, saving, the choice of jobs—is not the current tax rates but the tax rates that are expected in the future.

Congress can, therefore, improve current incentives without any increase in the current deficit by enacting now a schedule of future tax cuts. These precommitted tax cuts can be financed as they occur out of the automatic revenue increases produced by inflation and out of the savings that could result from a slowdown in the growth of Government spending. The commitment to a schedule of future tax cuts would give Congress and the Government agencies time to shape their spending plans to the lower level of available revenue. Thus, while an immediate tax cut generally means an increased deficit, precommitted future tax cuts can change incentives without any deficits.

Consider the problem of stimulating individuals to save more. Today the combination of inflation and high tax rates makes the real after-tax return negative for many individuals. To stimulate saving, the key requirement is to raise the real after-tax return that savers can expect to receive in the future on additions to their assets. One simple and direct way to achieve this would be to treat interest and dividends like capital gains; that is, excluding 60 percent of all interest and dividends from taxable income. Of course, if this 60-percent exclusion were allowed all at once in 1981 the revenue loss would probably exceed the increased saving. The Government's borrowing to finance this revenue loss would then absorb more than all of the increased saving—and the amount available for investment in plant and equipment would actually be reduced.

But what if the 60-percent exclusion were enacted now with its effective date postponed until 1985? The Government would clearly lose no revenue in the next 4 years. But households would have a strong incentive to start saving more immediately in order to have more assets on which to take fuller advantage of the lower tax rate when it becomes effective. Starting with a small exclusion in 1981 and allowing it to rise to 60 percent by 1985 would make the prospect of the full future exclusion more credible without changing the fundamental point that the immediate increase in saving can be substantially greater than the concurrent increase in the deficit.

The same idea of a precommitted tax cut can work to stimulate investment. Consider the effect of a major cut in the corporate tax rate—say from 46 percent to 36 percent—that is enacted now with

an effective date in 1985. Although there would be no change in tax rates from 1981 through 1984, firms would have a substantial incentive to increase their investment spending immediately because investments made during the next 4 years would benefit from depreciation at high tax rates while the subsequent profits would be subject to lower tax rates. Again, a gradual phasein of the tax rate reduction would increase the credibility and visibility of the future rate reductions.

There are other ways to stimulate investment with little or no decrease in tax revenue. Replacing the existing historic cost depreciation method with an indexed depreciation system for all future investment would immediately raise the aftertax yield on all prospective projects. Indeed, at the current high rate of inflation, indexed depreciation would offer a greater stimulus to investment that the Conable-Jones 10–5–3 plan for accelerated depreciation. Indexed depreciation would involve no immediate revenue loss and the future revenue losses would rise only slowly as the eligible capital stock grew.

I think this is really a unique time for beginning such a tax cut because of the substantial revenue inflow that can be expected in the next few years because of inflation. The opportunity to finance substantial structural reform that inflation gives back is an opportunity that shouldn't be wasted. I know there's a great deal of debate about whether such a tax cut, which I think is inevitable, should occur now or wait until after the election or sometime next year. I think it would be wrong to try to make that decision on the basis of countercyclical timing. I think we just don't know enough as economists and forecasters to use a tax cut for countercyclical purposes.

So I think the important question of timing is when one can have a good bill. To have a one-shot across-the-board rate reduction now would simply waste the opportunity for doing something more important of a structural sort. My sense is that Congress can start now to introduce a long-term series of tax cuts but if they can't, I'd rather wait until after the election.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you, Mr. Feldstein.

[The prepared statement of Mr. Feldstein follows:]

PREPARED STATEMENT OF MARTIN FELDSTEIN*

A Program of Tax Reductions

Thank you, Mr. Chairman. I am very pleased to be with your committee again.

I think that the current hearings are uniquely important. This should not be just another tax cut to stimulate employment. There is a unique opportunity at the current time to legislate a program of tax reductions that can have a profoundly positive effect on the economy in the decade ahead.

I say that the opportunity to reshape the tax system is now "unique" because of the vast increase in tax revenue that inflation has produced and can be expected to go on producing in the next few years. Congress can use this expanded revenue by enacting now a multiyear program of tax cuts that will reduce some of the existing strong disincentives to capital formation and production. And if this is done in the right way, such a multiyear tax cut could bring immediate increases in investment, saving and individual effort without any unwanted increases in the government deficit, either now or in the future.

*Professor of Economics, Harvard University. The views expressed here are my own and should not be attributed to any organization.

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In my brief prepared statement, I will explain how a series of percommitted tax cuts can have this desirable effect without unwanted deficits. I will give some examples of using precommitted tax cuts to encourage saving, business investment, and personal effort. I would be pleased to discuss specific ideas in more detail either during the question period or later.

EXPECTATIONS OF INCENTIVES

The most important thing to consider when thinking about a tax cut strategy is that all important economic decisions are based on expectations about the future. What matters for current actions—investment, saving, the choice of jobs—is not the current tax rates but the tax rates that are expected in the future.

Congress can therefore improve current incentives without any increase in the current deficit by enacting now a schedule of future tax cuts. These precommitted tax cuts can be financed as they occur out of the automatic revenue increases produced by inflation and out of the savings that could result from a slowdown in the growth of government spending. The commitment to a schedule of future tax cuts would give Congress and the government agencies time to shape their spending plans to the lower level of available revenue. Thus while an immediate tax cut generally means an increased deficit, precommitted future tax cuts can change incentives without any deficits.

Consider the problem of stimulating individuals to save more. Today the combination of inflation and high tax rates makes the real after-tax return negative for many individuals. To stimulate saving, the key requirement is to raise the real after-tax return that savers can expect to receive in the future on additions to their assets. One simple and direct way to achieve this would be to treat interest and dividends like capital gains—i.e., excluding 60 percent of all interest and dividends from taxable income. Of course, if this 60 percent exclusion were allowed all at once in 1981, the revenue loss would probably exceed the increased saving. The government's borrowing to finance this revenue loss would then absorb more than all of the increased saving—and the amount available for investment in plant and equipment would actually be reduced.

But what if the 60 percent exclusion were enacted now with its effective date postponed until 1985? The government would clearly lose no revenue in the next four years. But households would have a strong incentive to start saving more immediately in order to have more assets on which to take fuller advantage of the lower tax rate when it becomes effective. Starting with a small exclusion in 1981 and allowing it to rise to 60 percent by 1985 would make the prospect of the full future exclusion more credible without changing the fundamental point that the immediate increase in saving can be substantially greater than the concurrent increase in the deficit.

The same idea of a precommitted tax cut can work to stimulate investment. Consider the effect of a major cut in the corporate tax rate—say from 46 percent to 36 percent—that is enacted now with an effective date in 1985. Although there would be no change in tax rates from 1981 through 1984, firms would have a substantial incentive immediately to increase their investment spending immediately because investments made during the next four years would benefit from depreciation at high tax rates while the subsequent profits would be subject to lower tax rates. Again, a gradual phase-in of the tax rate reduction would increase the credibility and visibility of the future rate reductions.

There are other ways to stimulate investment with little or no decrease in tax revenue. Replacing the existing historic cost depreciation method with an indexed depreciation system for all future investment would immediately raise the after-tax yield on all prospective projects. Indeed, at the current high rate of inflation, indexed depreciation would offer a greater stimulus to investment than the Conable-Jones 10–5–3 plan for accelerated depreciation. Indexed depreciation would involve no immediate revenue loss and the future revenue losses would rise only slowly as the eligible capital stock grew.

For personal rate cuts, a slow but certain phasing-in would also achieve most of the benefits of a large immediate rate cut without a large revenue loss. An individual who is deciding whether to change jobs, to relocate, to "invest" in more schooling or training, or just to work harder in the hope of better promotions will look at future tax rates. Because a gradual phase-in could be financed by the automatic inflation tax windfalls and by a gradual reduction in the growth

of government spending, tax rates could be reduced by 30 percent over a few years without any deficits.

The supply side tax-cut goal of increasing incentives without budget deficits can be achieved in this way without depending on a miraculous response of labor supply or productivity. And to the extent that increases in individual effort and in capital accumulation raise national income over time, there will be greater tax revenues with which to finance either government spending or further tax reductions.

INFLATION GIVEBACKS

I have emphasized that the extra tax revenue that inflation will produce can be used to finance real tax cuts. Because of the progressivity of the tax schedule, each 10 percent rise in total personal income raises individual income tax collections by about 16 percent. This permits a 6 percent cut in tax rates without any reduction in the ratio of total tax collections to personal income. Over just four years, the cumulative tax reduction could be nearly 25 percent from this source alone.

Pruning the share of personal income that goes in federal personal taxes—not even counting the Social Security payroll tax—back to the ratio of 15 years ago would permit an additional real tax cut of 16 percent. Cutting the effective tax rate on corporate capital income—including corporate profits, dividends and interest—back to where it was 15 years ago, would reduce that revenue by nearly 30 percent or more than $35 billion at 1979 levels.[1] This $35 billion is itself more than 12 percent of the total corporate and personal tax collections.

The total tax cut—combining inflation givebacks and real reductions—can easily be between 30 and 40 percent over the next four years. This provides a unique opportunity for a series of tax changes that reduce the disincentives in the current tax structure. It is crucial not to let this opportunity be wasted in increased government spending. It is important also that the tax cuts specifically stimulate saving and investment and are not limited to across-the-board reductions in personal rates.

Although this means that a major reduction in personal rates—like the 30 percent Roth-Kemp proposal—would take more than three years, such a rate reduction should remain a key goal of tax reform. Congress would do well to commit itself now by legislation to a specific plan for giving back all of the future tax increases that result from inflation: Any of these givebacks that are not used to stimulate saving and investment would be applied to across-the-board tax rate reductions until all current rates are reduced by 30 percent. This would have the advantage of dividing the feasible tax reductions between capital formation incentives and personal rate cuts without sacrificing the goal of general rate reduction. When the 30 percent rate cut has been achieved, an automatic annual bracket rate adjustment could keep inflation from raising the relative tax burden.

COUNTERCYCLICAL TAX CUTS

Although this is a uniquely good time to begin a series of precommitted tax cuts focused on strengthening incentives, much of the public discussion is only about an old-fashioned countercyclical tax cut. The advocates of such a policy seem to have forgotten that economists and forecasters just don't know enough to use tax cuts to attenuate the business cycle. For a tax cut to reduce the current rise in unemployment, it would have to have been passed last year, long before the beginning of the recession was clearly in sight. A tax cut now would probably have its impact in 1981 and 1982 when the recession is past and the economy is expanding. Of course, the recession may potentially be worse than it now looks and output may continue to fall well into 1981. But we know too little about just where the economy is now going—and about the magnitude and timing of the impact of a tax cut—to recommend a countercyclical reduction in taxes.

The experience of the past thirty years shows that attempts at countercyclical fiscal policy have actually worsened the business cycle—expansionary policies overstimulating the economy and fiscal contractions deepening the recessions.

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[1] M. Feldstein and L. Summers ("Inflation and the Taxation of Capital Income in the Corporate Sector,"National Tax Journal, 1979) estimate the effective tax rate in each year and its relation to the inflation-induced distortions in the measurement of capital income. See M. Feldstein and J. Poterba ("State and Local Taxes and the Rate of Return on Nonfinancial Corporate Capital," National Bureau of Economic Research Working Paper No. 508, 1980) for an update of these calculations through 1979.

The lesson of this experience is that attempts at fiscal stabilization should be avoided in the short swings of the business cycle and saved as the ultimate economic weapon to be unleashed only if the economy falls into a deep and protracted depression. That is not a reason to avoid a tax cut now but it does imply that the current tax cut should be aimed at long-run goals rather than at the current recession.

SURVIVAL AND SUCCESS

I believe that our nation's economic survival and success in the 1980's will depend on the type of tax system we have. Now is the time to begin a serious restructuring that will restore incentives for saving, investment and individual effort. A firm legislative commitment to a gradual phasing-in of these tax changes can provide a major stimulus to current capital formation and individual productivity without any unwanted increase in the government deficit.

Senator BENTSEN. Professor Eisner, I'm very delighted to have you back again and we always appreciate your contribution to this committee.

STATEMENT OF ROBERT EISNER, WILLIAM R. KENAN PROFESSOR OF ECONOMICS, NORTHWESTERN UNIVERSITY, EVANSTON, ILL.

Mr. EISNER. It's a pleasure to be here again, Mr. Chairman.

The topic of savings is a very important one. It involves, of course, the acquisition of the means of future subsistence and very largely the potential contribution to economic growth.

I think I should like to turn a good bit of the conventional discussion by trying to bring attention to a number of certain facts about savings frequently ignored. We have charts, I see, on savings rates in front of the room and there are different savings rates indicated on the charts, but I should add that saving is much more varied than that.

There's a lot of discussion of the personal saving rate, which means the difference between disposable personal income and personal outlays. That's only a small portion of saving as an economist would view it or as we have to look at it in studying the economy.

Saving is any productive activity that involves the production of goods or services that contribute to future production. Therefore, saving includes not only personal saving; it includes business saving; it includes government saving.

Saving can take many forms. It can take the form of business acquisition of plant and equipment. It can take the form of acquisition of plant and equipment by government or by households. It can take the form of the acquisition of knowledge. It takes the form of the development of human capital. Indeed, on a subject to which I have been devoted and I believe the chairman has, encouragement to employment, employment tax credits can involve the most significant form of saving adding to productivity that we can imagine because they can involve getting work, particularly for youngsters, people without jobs, which gives them the human capital, the ability to produce for many, many years in the future.

Now if we recognize that, then we begin to see that many of the measures about which we talk which involve a stimulus to one form of saving as opposed to another involve a turning or switching. The public is directed to save in one way rather than another and the aggregate of saving is relatively little affected. Of the particular measures,

gimmicks, tax advantages, preferences in our tax structure, which is certainly already a crazy patchwork quilt of such preferences and distortions, all of these really do not add to total saving. They change the form of that saving, frequently in ways which tend to limit this contribution to productivity by preventing saving from being directed into the forms where a free market would find it and where it would be most productive.

I hope I don't surprise too many of you by coming here this morning, as I like to do on many occasions, as the apostle of free enterprise, of a free economy, of allowing people to save how they will and as much as they will. I don't think there is any particular reason for either the Congress or economics professors to say, "We have decided"—and I know this is contrary to prevailing views that the public is not saving enough—"We are going to make you save more." There could be occasionally times of pressing need in the country when that's done. There was one notorious occasion in the Stalin Russia of the 1920's where Stalin decided the Russian country apparently would not survive without a great deal of saving and he undertook essentially forced saving. I don't think that is the situation in our economy.

We remain the most prosperous country in the world. Our standard of living is still the highest except perhaps for a few smaller oil sheikdoms, and we should stop beating our breasts in dismay as to how bad off we are.

I will, however, qualify all this in the following way. While I believe in the free economy, clearly there are cases where the market breaks down, where we have a market failure. The one notorious outstanding example of market failure in this instance is the recession and involuntary unemployment. That does more to damage saving, to damage investment, than anything of which we can think.

In fact, for example, in the recession of 1974–75, we had a reduction of business, nonresidential fixed investment of some 17 percent. The forecast for the current recession, mine and others, is not quite as dismal, but still we are talking about perhaps a 12- to 13-percent fall, or on that order of magnitude, on business investment, really far more than we can expect to recover by almost any of the tax measure incentives that we have talked about.

The single greatest encouragement we can give to saving and investment and the greatest encouragement consistent again with free choice, is to see to it that people can make choices in business and make their decisions in a climate of prosperity of full employment.

In that regard, by the way, I guess I would differ from my distinguished colleague, Professor Feldstein, and suggest that a tax cut of a general nature is in order, not merely as a countercyclical device at this time, although I agree with him the time is already quite late as we talk of tax cuts coming into effect in 1981, as far as this current recession goes, we hope to be recovering by 1981. However, we need the tax cut because effectively taxes keep rising without the Congress doing anything and the increases in taxes are tremendous. We estimate swings in the full employment budget on the order of $70 billion. That's a tremendous drag on the economy, stemming from the high social security taxes, from the windfall profits tax on oil, and of course in particular from the bracket creep from inflation.

So to say that we will postpone action on taxes means in effect to say that we are going to allow taxes to keep rising and if we allow taxes to keep rising that will be a body blow to the recovery that we hope to have.

Now Professor Feldstein has offered some interesting ideas. I'm delighted to have them. I have been trying to offer some similar notions now for some time. I think he wisely stresses the fact that as far as taxes go, the critical matter is incentive effect.

That's a hard thing to get across to constituents because when we really come down to it, most taxpayers are not followers of economics. It's easy to tell them that we are giving you a tax cut not for their own good but simply to stimulate the economy. Most of them are interested in their own good and we are going to change the tax structure so they are not going to get any higher taxes. Now they don't know what you're talking about and I suppose you might take a good bit of the political steam for a tax cut out if you put it this way, and I wonder if that isn't healthy.

I'm very much afraid—and I don't mean to be cynical about this—when you come down to it, most people would like to cut their taxes. As Senator Long put it, "Don't tax me or him or you. Tax that man behind the tree." Everybody has a notion of let's cut taxes and they mean cut my taxes and people that save a lot tend to be wealthy and they tend to have a good deal of influence and they say, therefore, cut taxes on saving. I would hazard a guess—more than a guess—I think there's a lot of economic evidence of that and, again, some of my colleagues may disagree, but this is a rather long sophisticated disagreement—there's relatively little sound evidence that the rate of return on saving has much to do with total saving.

To say a bit on what basis we save, we save for our retirement and we are not about to decide that we are going to let the years of our maturity go down the drain because we're going to get only a 3-percent return instead of a 6-percent return. In fact, one could well make a case that one could save more for one's retirement if the rate of return were less because you realize you have to set aside more out of your income in order to have that necessary retirement income, for example, if you know whatever you set aside is not going to be accumulating year by year.

But back to the matter of incentives, I might suggest—and this I hope isn't too sacriligious and offensive—that in addition to Professor Feldstein's suggestion that we legislate a cut in the corporate tax rate effective sometime from now—and I have advocated that on numerous occasions—in fact, I would be happy to do away with the business taxes altogether. I would go the other direction on the investment tax credit.

If you want to stimulate investment now, I think there's a good reason to stimulate it now as opposed to the long run because of the current recession. I would say let us enact both a cut in the corporate tax rate effective some years from now and the elimination of the investment tax credit some years from now. If we announce, for example, that 2 years from now the corporate tax rate would be cut by 10 percent and the investment credit would be eliminated, stop to think how much additional investment you would get. You would get a great deal because businesses would have a double incentive to invest now. If they

invest now they get the credit. If they wait 2 years they don't get the credit. If they invest now all those expenses of investment are tax deductible against their higher corporate rate now and if they postpone investment they will be deductible only against a lower rate in the future.

Now that brings me then to another matter of very temporary concern, the famous 10–5–3 or Conable-Jones Act, the capital cost recovery act. I would suggest that this is something, with all respect to the good intentions of the great number of congressional sponsors, that goes exactly the wrong way.

Aside from the fact that almost all of these measures, from my own research and from econometric models we analyze, would show and have shown—aside from the fact these measures involve $1 of tax loss for every 50 cents of added investment, 10–5–3 has the particularly dubious characteristic of a phase-in provision such that there is every disincentive to investment, contrary to what Professor Feldstein advocated. For by putting off maximum benefits, you're telling firms, if you acquire new property, you get a slight depreciation advantage this year, a somewhat greater one the next year, a somewhat greater one the next year, but only on property you acquire in 5 years will you get the full tax advantage.

Now I don't know how calculating businesses will be, but, of course, we set these tax laws and changes with that in mind. If they are calculating what they would wisely do, they would say, well, I'm glad Congress passed this great bit of largesse to save us no less than $80 billion in taxes 5 years from now, and that's when we should do our investment, 5 years from now when it will save us taxes. There's no sense in acquiring a lot of plant and equipment now without the major tax advantage we're going to get later.

Now I might comment just a bit before I close on the issue of social security, with some boldness, because again Professor Feldstein has written extensively on this matter and I beg to differ rather fundamentally with some of his arguments on the subject.

First, I should say on social security the notion that we have to worry about social security going bankrupt, that we can't expect payment because the fund will be insolvent, involves really a great deal of heat and fright and provides little light as I put it.

The extent to which social security benefits—those promises will be honored, depends after all on simply the commitment of the taxpayers, the voting public, at the time when many of the rest of us will be getting our social security, on the productive capacity of the American economy at that time.

Now that means that in order to provide adequate social security in the future we have to see to it that in the future we have a productive economy. That involves, by the way, not only having adequate capital facilities and capital of all kinds, not only private capital but public capital, not only physical capital but human capital; it involves having people work in the future. That means that you should also see to it that the social security system does not discourage labor, as still unfortunately it does by encouraging early retirement so that people can avoid losing their benefits.

The main argument that has been made that social security discourages saving involves, to my mind, one of the typical confusions on

the issue of saving. It fails to distinguish between the individual and the aggregate, between what one person does and what happens to the entire economy.

In fact, when we have a situation of unemployment, social security as it is currently financed in this country tends to make people wealthier, tends to make them consume more. That does not mean less total saving because as we all know from what we call the paradox of thrift, we all know in economics at least in our own jargon, if in a period of unemployment or recession of inadequate demand people consume more, that does not reduce total saving because the individual consumption adds to other people's incomes and therefore adds to their consumption and their saving, and total saving is larger than it would otherwise be.

On the other hand, if you have a situation of full employment and we have a social security system which in fact gives people more wealth in terms of expected retirement benefits, that will again lead them to try to consume more and the effect of that, unless monetary policy is quite diverse, is actually to raise total spending and thereby raise prices. In fact, while I guess the argument gets a bit subtle, it leads to a substitution of a debt by the Government in the form of social security for the explicit debt in terms of Government securities which go down in real value with inflation.

Let me close by returning then simply to the emphasis that I'd like to bring to you that saving is many things. It is the investment by all sectors of the economy: households, government, business, and nonprofit institutions. It is saving in all forms of education, of training, of research and development, of the acquisition of new technology, and not merely in the plant and equipment acquired by business.

The business plant and equipment investment amounts to no more than 20 percent of total capital formation in the American economy appropriately defined, and I must look coolly upon tax inducement to saving in particular forms which leave 40 percent of the black 17-year-olds functionally illiterate, as William Buckley pointed out recently.

The way in which we should move if we are to invoke government policy and tax measures is to encourage employment, to see to it that we use all the resources of the economy, and then have a full flow of saving of all kinds, tangible and intangible, by government, business, nonprofit institutions, and households, from an economy living up to the maximum of its potential.

Thank you very much.

Senator BENTSEN. Thank you, Mr. Eisner.

[The prepared statement of Mr. Eisner follows:]

PREPARED STATEMENT OF ROBERT EISNER*

Savings for the Future

Saving for the future is a very important topic. Public discussion of it has unfortunately on occasion been confused and dominated by special pleadings.

The subject is important because for both the individual and for society current saving provides the means of future subsistence and, possibly, economic growth. Confusions relate to the failure to distinguish on the one hand between acts of individual saving and saving of the economy and, on the other, between particular forms of saving and saving in the aggregate.

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Individual acts of saving do not necessarily imply saving for the economy. Saving is appropriately defined as the difference between income and consumption. If, for example, I save by abstaining from consuming the services of my barber, the immediate effect is to reduce his income so that his saving, the difference between his income and his consumption, is reduced by as much as my saving increases. If he attempts to maintain his saving in the face of his reduction in income by consuming less, he in turn reduces the income of others, thus reducing their saving and/or forcing them to consume less. The ultimate consequence of my attempt to save, whether I put my savings under the pillow, in a "savings institution," or in a security (which may be one that the barber sells) may well be a reduction in total saving in the economy. For as incomes decline, saving, which comes out of and is most dependent upon income, declines as well. This phenomenon, whereby individual efforts to save more result in less saving in the economy as a whole, referred to as the "paradox of thrift," is of particular relevance in a period of recession. Inducements to save more, entailing abstention from current consumption, can only aggravate a recession, and hence bring increased unemployment, less real output and less saving and business investment.

A second confusion relates to the nature of saving. An individual believes that he saves when he adds to his accumulation of cash, securities, real assets or pension rights, thus enabling him to spend more in the future. For any such individual saving in fact to provide the resources for additional goods and services in the future, it must be embodied in productive capital. This will not be so if an act of saving of one individual induces equal or greater dissaving in others, as we have just noted. It will also not be so if the saving takes the form of unproductive capital.

It is widely believed that saving which flows into business investment adds to productive capital. This is likely to be so to the extent that business investment is correctly undertaken on the basis of its contribution to real product and profit. This will not be so if the business investment is misguided, either by faulty signals in an insufficiently competitive market or by deleterious government intervention. It is clear that government controls or requirements for additional business facilities may do little or nothing to increase output or productivity or may even reduce it. It somehow is not always so clearly seen that business investment brought on by government intervention in the form of special tax advantages can also be nonproductive and lead to a reduction in output, net of depreciation, available to the economy. Indeed, there may be some presumption that such government-induced investment is likely to be nonproductive. For otherwise, it should have been undertaken by profit-oriented business without the intervention.

What is most important in this context is that total saving in the economy takes many forms. Requirements or tax inducements to increase saving in one form may actually encourage less productive saving at the expense of more productive saving. One should expect that business investment in plant and equipment, even with less than perfect competitive markets, would on the whole be productive without government intervention. But in addition to the saving going to business investment in plant and equipment there is saving that goes into investment in research and development, training and education, however these are measured in the national income and product accounts. A broad measure of saving and capital accumulation would include plant and equipment investment by nonprofit institutions and by government at all levels, household expenditures for durable goods and vast investment in human capital undertaken by government, nonprofit institutions and business. In the course of studies of extended measures of income and product, I have estimated that business plant and equipment and investment is no more than 20 percent of total capital formation or broadly defined saving in the American economy.

Tax inducements to saving in the form of business plant and equipment investment which leaves 40 percent of black seventeen-year olds functionally illiterate, millions of youths and older Americans without adequate job experience or training, and declining resources to research and development in new technology are hardly optimum. It is from this perspective that I approach the specific questions of interest to the Committee in this Hearing.

Can an individual succeed in saving for a secure retirement in a time of high inflation?—Many individuals succeed very well in saving at a time of high inflation. They save by buying assets, frequently on borrowed money, which rise with or more than the general price level. The name of the game, indeed, is capital

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gains. Those who have enjoyed them, whether with homes bought on cheap mortgage money, land and commercial real estate which have risen sharply in value, securities for the wise or lucky ones, or commodities including petroleum, have done very well. Restrictions on interest rates paid by banks and savings institutions along with inequities in the tax code have, to the contrary, penalized very severely those who have saved or tried to save by accumulating other kinds of assets. The successful savers who have done very well seem to have been more effective in shaping the tax code to suit themselves than in equalizing the potential return from saving as between individuals and the forms of saving differentially open to them.

The bulk of individual saving for retirement for most Americans is constituted by social security, private pension funds, and equity in owner-occupied housing. It is probably in the private pension area that high inflation has most seriously jeopardized retirement income despite major tax-deferral advantages. Aside from continuing and increasing efforts to make available a sound, honest and equitable private pension system. it may be highly desirable to offer inflation insurance in the form of indexed government bonds or other devices which would make it easier for private pension funds to offer adequate protection against inflation.

The effects of inflation on the motivation to save are, perhaps paradoxically, more likely favorable than unfavorable. While some of my colleagues in the economics profession may disagree, it would appear that the bulk of individual saving is motivated by necessity rather than expected return. Most of us are anxious to provide for that rainy day and particularly for the period of our maturity where we expect to be unwilling or unable to work. Inflation and the associated uncertainty of the future may be just as likely to make us try to save more as to decide that it is all not worth it and we should rather go out on a spending binge. Some popular perception to the contrary stems, once more, from improper measures of saving. In the face of inflation, we may decide it foolish to try to provide for the future by putting our money in a passbook savings account. We may rather, in the face of rising prices, borrow to invest in new homes, automobiles, appliances and durable goods of all characters.

As to how personal saving affects economic growth, that depends very directly on the form of capital accumulation which the saving constitutes or in which it results. If the saving finances gambling casinos it will presumably increase the production of marketable gambling services. If a future generation loses its taste for such gambling, the saving will in all senses have proved destructive of economic growth.

If the personal saving finances government deficits used to dig holes in the ground, and then fill them again, or finances the dissaving of those on welfare or otherwise living on government handouts, it will not affect economic growth favorably. One may and indeed must make a similar argument with regard to personal saving to finance deficits for expensive new defense programs. At best, such programs, by contributing to full employment and by adding to national security, protect the economic growth of which the economy is otherwise capable. At worst, if the defense expenditures do not in fact add to national security and do crowd out productive investment, public or private, they reduce economic growth.

Personal saving which finances public or private deficits incurred for productive capital improvement, in physical or in human capital, will contribute to economic growth. This will be true whether the personal saving finances new planes for private airlines or new publicly owned airport terminal facilities, whether it finances private investment to produce more efficient automobiles or public investment to provide better roads or mass transit, or research and development and education and job training.

As to the effect of saving on the competitiveness of the U.S. economy and the security of American jobs, we must again dispel considerable confusion as between the part and the whole, particular individuals or sets of individuals or industries and the total American economy. The American economy as a whole is competitive in world markets, at least to the extent that it is not prevented from being so by government interferences with trade in the form of tariffs, quotas, orderly marketing arrangements, trigger prices, embargoes and, even more fundamentally, restrictions on the free movement of capital and labor. Concerns about the "competitiveness of the U.S. economy" in public discussion extend rather to the varying difficulties in competition for different segments of the American economy. American wheat farmers can do very well producing

to sell in the world markets. So can our manufacturers of planes and computers and the producers of American movies. Total American exports are projected at some $320 billion for 1980, just about the same as imports, and considerably in excess of imports other than some $85 billion which we will be paying for foreign oil. To say then that the American economy as a whole is not "competitive" in world markets is nonsense.

The only element of truth, or half-truth, in this statement is that some American industries have been lagging relative to their foreign competitors while others have been advancing. This is of the nature of dynamic economies and the pain, along with the pleasure of progress. To some extent our relatively declining industries may be victims of their own follies, whether in unwise investment or inadequate attention to technological advance or in poor labor performance at relatively high wages. In some cases such relatively declining industries have corrective devices within their means and will apply them if government intervention in the guise of "protection" does not save them from the necessity of self-support.

All of this applies directly to the issue of saving. Market forces should attract saving to those sectors of the economy where saving can be most profitably employed, whether to increase existing comparative advantage or to reduce existing comparative disadvantage in world markets. Where saving is not so lured by expected returns, there is an a priori presumption that it should not be lured or directed by government protection or tax inducements. To do so would reduce the overall productivity of saving and of the economy as a whole. It would offer more capital formation in industries and sectors where it is less productive while depriving other industries and sectors of capital formation which would be more productive. It would hence maintain the "security" of relatively less productive jobs at the expense of more productive new jobs in the industries that are truly competitive.

As to the encouragement and discouragement of personal saving, recent discussion of social security has offered much more heat and fright than light. First, of course, the "solvency" and value of social security promises depend essentially upon the commitment of the government and taxpayers that will have to honor them in the future and on the productivity of the future American economy. They have little or nothing to do directly with the amounts of money in trust funds or how contributions to those funds are financed.

On a somewhat sophisticated level, it has been argued, particularly by Martin Feldstein, that a pay-as-you-go, unfunded social security system such as ours has major effects of reducing personal saving, capital accumulation and growth. The argument fundamentally is that under such a system at any point of time those currently alive expect future benefits, the present value of which is greater than that of their current and expected future taxes. This increase in privately perceived wealth results in more current consumption. Hence with a given total of income and product there must be less saving.

The argument above is not infrequently confused by a failure to distinguish between personal and total saving, again somewhat bedevilled by the conventional definition of personal saving. Thus, it is maintained that saving is reduced because individuals contribute to social security instead of to the private accumulation of saving. This, however, is quite fallacious. Whether individuals reduce their consumption in order to contribute to a public or a private retirement fund does not affect the aggregate of saving. The amounts of their contributions do, and that of course relates to the wealth effect just cited.

But even in the fundamental sense, the argument is highly doubtful. There is of course the question as to whether public confidence in the real future payments of social security is now, or ever has been, so great as to lead it to increase current spending and reduce saving. There is also an argument that if the current generation takes account of social security taxes to be paid by its children it will consume less and save more in order to offer greater bequests to its children.

I challenge the argument that social security reduces saving as stemming basically, however, from a confusion again between individual saving and saving of the economy as a whole. In situations of unemployment or recession, to the extent that social security and the promise of it tend to sustain or increase consumption, it results in more not less total saving. With greater consumption there is more production and income and hence more saving—the paradox of thrift I mentioned earlier.

In conditions of full employment, social security is still not likely to reduce saving. For then, to the extent that it adds to total demand, it has the effect of raising prices. There is no reason to believe that all prices will not, as a first approximation, go up proportionately. The final result is then higher prices and a lower real value of the government debt. Hence social security, to the extent it

contributes to a desire to consume more under conditions of full employment, only has the effect of giving the public holdings of implicit government debt in the form of social security commitments at the expense of explicit government debt in the form of the real value of holdings of government securities.

There is one real sense in which our existing system of social security does affect saving adversely, and that is in its discouragement of work by the elderly. Relatively early retirement induced by the loss of social security earnings from full time work may encourage some people to save more in order to provide more adequately for that early retirement. But by reducing total employment in the economy, early retirement reduces total income and output and again reduces aggregate saving, which depends so greatly on income. A major solution to this problem is to be found in offering full social security benefits to those eligible regardless of earned income and in structuring social security earnings on a sound actuarial basis so that individuals have a fair incentive to work as long as they are willing and able.

We have had a variety of proposals to alter tax rates in the interest of increasing saving and investment. I am aware that such proposals have wide support from the Congress and among business organizations. I am forced to view them, however, as frequently inequitable, likely to be ineffective in stimulating business investment and harmful in their overall effects on capital formation and productivity.

Action to exempt portions of savings accounts and other interest from taxes is one case in point. Savings accounts have clearly offered grievous losses to their holders as a consequence of inflation. These losses have stemmed primarily, from governmentally imposed restrictions on the interest rates savings institutions can pay. The recently enacted relaxation and removal of such restrictions will, when carried to completion, permit interest rates paid by savings institutions to reflect inflation. Those who save through such institutions will then receive a reasonable degree of protection as a consequence of the free play of competitive forces in financial markets. To offer tax reduction only for interest paid by savings institutions, however, will distort financial markets and give unfair advantage to such institutions and those who save through them.

As exemptions are expanded to other forms of interest payments, this may extend the distortions further. Raising capital by borrowing is encouraged at the expense of raising equity capital on which taxable dividends would be paid. Extending the tax exclusion to dividends would imply discrimination against noncorporate business.

With all, the stimulation to saving, whether or not desirable, would be minimal. Economists are far from agreed that higher after-tax yields have much effect on saving or even the direction of the effect. To the extent people save in order to have spending power at a future time, such as for retirement, lower returns make it necessary to save more. Simply enough, the saver, with a lower after-tax yield, cannot rely upon as much compound interest return for his eventual nest egg. Further, if equity considerations set an upper bound to the amount of the exclusions of interest, there will be little effect on saving because the large savers, while receiving a "windfall," if they are already over the upper bound, will have no incentive to increase their saving. In general, exclusion of some forms of capital return from taxation, to the extent it is effective in altering saving flows, merely tends to divert saving to those forms without increasing its total amount and without necessarily having clearly calculable effects upon the direction of capital formation.

Proposals to affect capital formation by directly stimulating business investment are also receiving wide support. These proposals are defective in principle to the extent that they embody a government effort to determine the amount and direction of business investment. Business should be free to invest as much as seems optimal in terms of business considerations of profitability from plant, equipment and inventories. Business should not be induced by special tax concessions to invest more than is profitable. To induce a firm to acquire—unprofitable new machinery or buildings merely for the tax advantage, even if that can be done with only modest loss in tax revenues, is the way to lower productivity, not to increase it.

The very notion that business investment adds to productivity is based upon the presumption that business invests freely on the basis of its own private calculations. For except when it errs, and competitive forces are expected to

punish and eventually elimilate those who err, business will invest when it adds to productivity. If the government gives a tax break to a ditch digger to buy a second shovel when he needs only one, it will only be misallocating resources to unnecessary production of shovels.

Most prominent in recent consideration are proposals to stimulate business investment by accelerating depreciation for tax purposes. The Conable-Jones Capital Recovery Act offering "10-5-3" depreciation has particularly wide support. There are two related arguments for this proposal and others like it. The first is that government should actively try to promote more business investment than business would undertake on its own. I have just stated my objections to this argument. The second is that government should not encourage more investment than would be undertaken with a neutral tax system, but acceleration of depreciation is necessary to counter the discouragement of investment in existing tax policy. With regard to depreciation it is asserted, in particular, that inflation has brought on a situation where the value of tax depreciation has been sharply reduced because of the higher interest rates and rates of discount that must be applied to the eventual tax savings from depreciation deductions or, alternatively put, because the original cost depreciation will fall drastically short of replacement costs.

There is certainly truth in the assertion that inflation has distorted the tax treatment of depreciation. It lowers the relative value of tax depreciation to the firm and to that extent makes capital acquisition more costly. But inflation has many distorting effects. If we are to begin to correct for them, why start and stop with depreciation? To the very extent that tax depreciation is insufficient because of inflation, inflation has raised the value of existing assets. Holders of such assets, in the form of plant, equipment, land or precious metals, enjoy capital gains, whether realized or unrealized. When they are realized they are of course taxed, but no more than 40 percent of most capital gains is now included in taxable income. And where gains are not technically "realized" there is no taxation at all.

Of further moment, businesses frequently borrow in order to invest. Since borrowing costs are tax deductible, inflation offers a double advantage. As nominal interest rates rise with inflation, borrowers save more in taxes from their deductible interest payments as well as the opportunity to pay back their loans in dollars depreciated by inflation. And they then have capital gains, lightly taxed or not taxed at all, on the investments that they make with the cheap borrowed money. This phenomenon has become very obvious in the housing market, where huge surges in interest rates have, until recently, been accompanied by a major boom stimulated in considerable part by the lure of capital gains.

Although it is widely stated, there is little evidence that the complex of forces related to the inadequacy of tax depreciation has in fact limited capital formation. Nonresidential business fixed investment, until the current recession, was running at pretty much a record ratio of 10.8 percent of gross national product. While the issue remains one of dispute in the economics profession, my own past and continuing research indicates that changing tax depreciation, or other investment tax parameters such as the investment tax credit, has relatively little effect on investment. A reduction of ten billion dollars a year in taxes by means of accelerated depreciation, for example, is not likely to raise business investment by as much as $5 billion. My estimates and those I am deriving from a number of large econometric models suggest in many cases a considerably lesser bang for the buck. The 10-5-3 proposal, in its effort to reduce the immediate loss of tax revenue, estimated to come to some $80 billion per year by 1987, may actually have negative effects upon current investment because of its phase-in provisions. Rational business firms may well decide to postpone capital investment which will have only modest "capital recovery" tax advantages in the immediate future but will have very considerable advantages if undertaken at the end of the five-year phase-in.

There is one major role for government tax policy in affecting saving and investment. That is to keep the general level of taxes sufficiently low so that we may maintain general prosperity and relatively full employment. The recession of 1974-75 caused a drop of some 17 percent in real, nonresidential business investment in plant and equipment. The current recession is expected to bring drops in investment which, if not quite as great, would be far more than what could be

compensated for with all of the various tax incentives ostensibly designed to stimulate investment.

Personal saving, the difference between disposable personal income and personal outlays (largely personal consumption expenditures) is a poor measure of personal capital accumulation, or increase in net worth, let alone saving or capital accumulation in the economy. For that broader, more appropriate measure of personal capital accumulation would include capital gains, as in housing and securities, as well as investment in human capital. Measures to stimulate personal saving, narrowly defined, may merely change the mix in total or aggregate saving. The distortion effects may reduce the productivity of saving and even decrease its aggregate amount.

In the current situation, the greatest stimulus to personal saving and all saving can be found in moving the economy back in the direction of full employment. This suggests the advisability of a early and substantial tax cut, perhaps in the magnitude of $40 billion plus elimination of the major payroll tax increases scheduled for January 1. All of this tax "cut" would really be merely a partial elimination of, or compensation for, the massive tax increases which have already occurred or will be taking place because of the inflation-induced personal tax bracket creep and profits taxes on oil, as well as the social security tax increase. The choice facing the Congress and the Administration is really not between a tax cut or no tax cut but rather between allowing taxes to increase under existing law or whether to counteract that increase. To allow the currently scheduled tax increases do both to existing legislation and the continuing inflation would threaten to aggravate and extend the current recession and deliver serious blows to saving and investment.

Beyond anti-recessionary action, if broadly defined capital formation, productivity increases and growth are our goals, a program of lower taxes and increased government expenditures of an appropriate nature may well be in order. We may encourage research and development activities both by direct government sponsorship or expenditures and by tax incentives. We may wish to encourage more job training as well as broadly defined education.

There is a basic philosophical or ideological question as to whether it is the business of government to encourage people to save more than they would by their own free choice. To the extent government interferences or bias in the tax system have discouraged saving, such bias should be removed. It is really not clear, however, that in all of the crazy-quilt patchwork of our tax system, we have on balance discouraged saving. In some instances we have. In other instances we have clearly offered special tax advantages to those who accumulate.

There is one area of saving and investment, both for the individual and for society, where we may anticipate that the free market solution leads to insufficient saving. This is in regard to investment in human capital, particularly in the training and work experience which makes individuals productive over their lifetimes.

It is likely to pay individual, profit-maximizing firms to acquire all of the plant and equipment that is productive or profitable. It is not likely to pay firms to invest in human capital in high-risk youth, particular ghetto blacks, or women or others. For that investment cannot be "captured" by the employer. If the risks turn out well, employees take their newly found capital elsewhere; in any event, the original employer gains little or nothing.

Government policy should be directed to correcting or compensating for market failures where it is possible to do so. The market failure of unemployment is a prime example. That can be met in part in government programs for training in jobs. It should be supplemented in a major way by incentives to employers to increase employment of youths, minorities, women, veterans and all others who by their very unemployment give evidence of a need for corrective action. I have written elsewhere on the desirability of reducing or eliminating government taxes and other curbs on employment and on instituting both selective and general employment tax credits or subsidies.

It is in this direction that we should move to make possible a full flow of saving of all kinds, tangible and intangible, by government, business, non-profit institutions and households, from a economy living up to the maximum of its potential.

Senator BENTSEN. Professor Brownlee, we are delighted to have you come across the country to be with us today and I look forward to your testimony.

STATEMENT OF OSWALD H. BROWNLEE, PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA, MINNEAPOLIS, MINN.

Mr. BROWNLEE. Mr. Chairman, I am grateful for the opportunity to appear before the committee again. It was about 3 years ago that we held hearings of this variety and I was tempted to submit the same prepared statement I submitted then since the truth espoused then is truth now.

Let me try to answer some of the questions which you specifically raised in your letter of invitation, but first, let me talk a little bit about saving and the results which additional saving bring to the economy.

You have a chart [indicating] which shows Italy having the highest saving rate among the various countries that you have listed. I'm sure that Italy does not have the highest rate of growth. The country that I've watched for a number of years, Argentina, is reputed to have had a rate of saving which is approximately equal to or larger than that of the United States and has not been growing for 20 years. In fact the country's income may have declined over this period.

So, saving is not the answer by any means to all of our problems. The form in which saving takes as well as the quantity of saving is important and Professor Eisner pointed out that our tax structure or our investment incentive structure encourages a pattern of investment such that rates of return before taxes have differed very substantially across the economy.

The rate of return to investment in corporate capital, taxed at the 80 percent, which Professor Feldstein mentioned has to be very high before taxes in order to produce an aftertax rate of return the same as that produced by housing. It's my contention that we have too much of our capital stock invested in owner-occupied housing.

In the same way, we are probably investing too much of our capital in resources designed to obtain usable energy from solar energy and in investments in insulation and other things. I would favor cleaning up the tax structure and getting rid of the various and sundry gimmicks which you have introduced, including such things as the investment tax credit, in order to bring before tax rates of return more nearly together.

With respect to the factors that affect saving, it is certainly true, as Professor Eisner pointed out, that people save in order to smooth their consumption over their lifetimes and that they will save, as has been demonstrated for the future, even if rates of return are negative. But that does not mean that the responsive of saving to its rate of return is small or negative. Mr. Boskin, who's sitting on my right, has produced evidence which I think is fairly conclusive that saving responds fairly elastically to its rate of return and suggestions from studies made by Mr. Feldstein's group indicate that, if anything, Mr. Boskin's estimates of this responsiveness are too low. When these estimates were produced 7 or 8 years ago people thought perhaps he was cheating and that they were too large. Now the pendulum seems to have swung the other way.

Regardless of how elastic saving is to its rate of return, the present tax structure makes the price of future consumption relative to the price of current consumption extremely high and we ought to modify the structure in order to more nearly equalize these prices.

The obvious way in which to do this would be to switch from the system of income taxation which we have at the present time to a system whereby we tax expenditure, and to a certain extent we have done this for some kinds of incomes; namely, the income that is received by individuals in the form of contributions by their employers to their pensions. Part of this income is not subject to taxation. Extension of this principle to all forms of saving would be approximately equivalent to an expenditure tax.

If we are really serious about equalizing or trying to equalize the price of future consumption relative to the price of current consumption, then a move toward expenditures taxation seems to me to be in order.

You asked about the competitiveness of U.S. economy and the security of American jobs as it related to saving. I'm not quite sure what you mean by competitiveness of the American economy. If you mean our ability to export automobiles and steel, we are not at all assured that additional saving will increase the competitiveness of the automobile industry or the steel industry.

As long as there is international trade that is not tremendously impeded by artificial barriers, we will be exporting something. What we will export will depend upon our comparative advantage, and I doubt that saving will have very much impact on that.

You also asked about the future of the social security system and saving. Our social security system represents a system in which the retired generation has the right to tax the working generation, and the willingness of the working generation to contribute toward the income of the retired generation may depend upon its productivity. Insofar as saving contributes to a somewhat larger capital stock and increases productivity, there is a relationship between saving and social security. However, I consider it a very tenuous one.

Our major social security problems are not very closely related to the problem of saving.

You also asked whether it's possible for individuals in an economy in which there is inflation to save for the future. The Latin American economies have had inflation—some of them for more than a century. Brazil, as far as I know, has had inflation since it became independent of Portugal which was about 1840. Chile has had inflation for almost a century, and Argentina has had inflation since 1950. Savings, of course, are positive in these economies.

The negative impact of inflation upon saving in the United States has been primarily the result of the inflation not being anticipated. People trusted the Government to maintain a stable dollar and the Government failed them. So their savings have yielded negative returns primarily because they, in not expecting inflation, did not take the steps to protect themselves. Had we known that the inflation rate was going to be 10 percent we would have made investments which yielded returns greater than 10 percent.

Now a way in which we can protect ourselves, and a way in which the Latin Americans do it, in periods in which we do not know what the future rate of inflation will be, is to index. The Congress, in my estimation, has done almost everything that's possible to prevent us from protecting ourselves against inflation by not indexing the tax structure. Mr. Feldstein has pointed out the impacts which inflation

has had upon effective tax rates through overstating the earnings of businesses and real interest earnings of individuals. We are taxing capital as well as capital income.

Senator BENTSEN. Professor Brownlee, if you will excuse me, I have a conflict with the Finance Committee. Congressman Brown will chair the hearing and I look forward to reading the rest of your testimony and also Professor Boskin's and Professor Bailey's.

Representative BROWN [presiding]. Mr. Brownlee, are you finished with your presentation?

Mr. BROWNLEE. Let me make another possibly 30-second remark.

I consider the most important tax reform to be that of correcting the tax structure for inflation. Even countries like that of the United States—Sweden, Canada, and some other European countries where inflation rates have not been significantly different from those of the United States, as well as Latin American countries—have taken that step and I consider it not only regrettable but to some extent a disgrace that the Congress has not put this foremost on their agenda.

Thank you.

Representative BROWN. Disgrace is probably not the word to somebody who's pushed into higher tax brackets. They've probably got other words to use.

[The prepared statement of Mr. Brownlee follows:]

PREPARED STATEMENT OF OSWALD H. BROWNLEE

Saving for the Future

Approximately 3 years ago I testified before this committee on the "Role of Federal Tax Policy in Stimulating Capital Formation and Economic Stability." At that time we were emerging from a recession, a Presidential election had been concluded and a new campaign was just beginning. Now we are in the midst of a recession, much more concerned about inflation than we were 3 years ago, and a Presidential election is soon to be held so that a campaign will come to an end. Nevertheless, the basic laws of economics are as valid at the end of a Presidential campaign as they are at the beginning and in recession as well as inflation, so much of my testimony today will repeat some of the things I said 3 years ago.

The chairman's invitation has listed several specific questions of interest to the committee. Let me begin by considering those that relate to the relationship of saving to economic growth, and whether personal saving should be encouraged.

I shall define economic growth as the rate of growth in the per capita income of an economy, acknowledging that per capita income is not unambiguously measured and that—if it were—many persons would not accept it as the principal indicator of an economy's performance. Nevertheless, I believe that the measure is more or less what the committee has in mind when it considers economic growth. Strictly speaking, the saving rate does not affect the long-run growth rate. An economy with a high level of saving may be growing at the same rate as one with low savings. However, the absolute increments in income need not be the same. Furthermore, during the transition from one long-run equilibrium growth path to another one which displays higher per capita income, the rate of growth increases. A higher rate of saving generally results in higher per capita income than would otherwise occur because it results in a higher ratio of capital to labor.

The per capita income level, however, depends upon many factors including the manner in which the additional capital made possible by the saving is used. Some economies with relatively high rates of saving have experienced little increase in per capita income because the investment made possible by the saving was directed into projects that had very low rates of return. Some projects produced negative returns, i.e., they reduced the income of the economy. Income per employed worker or some similar measure is often used as a growth indicator and usually is referred to as "productivity." There has been much con-

cern in the United States about the trend of this indicator, i.e., about the slow rate of growth in productivity. Although the United States recently has experienced low rates of saving concurrent with a slow growth and sometimes a decline in productivity, I would not attribute the low rate of productivity increase solely to the low rate of saving. Productivity in the United States has been rising at a rate lower than that in some of the rest of the world for a considerable period of time, and there are many causes for this slow rate. They include workers' attitudes toward work and the channeling of a larger proportion of our resources into providing things that are not reflected in the usual measure of output (more has gone into meeting environmental and safety standards and complying with the generally increased level of regulation) as well as the low saving rate.

More saving directed into the highest yielding projects will mean higher income levels a few years from now. However, even though I would expect productivity to eventually rise if saving were increased, a higher saving rate is unlikely to solve the productivity problem in the immediate future.

The competitiveness of the U.S. economy and the security of American jobs are outcomes that should not be related to the economy's saving rate. For a given structure of transport costs and artificial trade barriers, the pattern of international trade and of domestic production is determined by comparative advantage. It may cost more in dollars to produce everything in the United States than it does abroad, yet the rest of the world would find it advantageous to trade some of the things it produces for some of the things produced in the United States. If the rest of the world is willing to trade with us (and we are willing to trade with them) and trade barriers don't cut off most potential world trade, we will always be "competitive" in producing some things. The products in which we are competitive may depend upon the saving rate. However, I will not guess how saving affects the details structure of the economy. Furthermore, I do not believe that economic policy with respect to saving should be guided by notions as to what the structure of the economy should be. I would favor the structure that yields the largest income for any level of saving.

Should personal saving be encouraged? The present environment in the United States discourages saving by making the reward for saving artificially low. If removing these wedges between the value of saving to the economy as a whole and its value to the saver would encourage saving, my answer to the question is an unqualified "yes!". I see no reason for including people to save more than they would if the choices available to them reflected the true prices of consuming today and postponing consumption through saving.

Most saving takes the form of the purchase of an earning asset. And with some exceptions, such as some pension accounts and owner-occupied housing, the income tax is levied on the income saved as well as the income earned from the asset. The income from equity capital invested in corporate business is subject to the corporation income tax as well as the personal income tax. Because of the manner in which depreciation is computed for tax purposes, the effective rate of taxation on the income of corporations can easily reach 75 percent for some classes of taxpayers. Because of inflation, the current tax structure can be confiscatory, i.e. not only is all of the income from capital taxed away, but some of capital itself is taken by the Treasury.

We had hoped that the inflation would be a short-run phenomenon, but these hopes have not been realized. Although inflation is ranked at the top of the list of ills being suffered by most people, the Congress of the United States has not yet indicated that it is willing to take effective action to bring the inflation to a stop. If we insist on budget deficits that run from 2 to 3 percent of GNP and on the personal income tax as the mainstay of the tax structure, the personal and corporate taxes should be automatically adjusted so that the real taxable income does not rise with the price level. This can be accomplished by adjusting the capital base and indexing the tax brackets.

Saving is the manner by which most individuals smooth out their consumption patterns over time. Rather than feast when their incomes are relatively large and fast when these incomes are small, most persons and families prefer to save some of the income received in their highest earning periods and spend it when their income has declined—usually in old age. Saving takes place even when it is known that the return to saving is negative. However, the evidence—both direct and indirect—supports the belief that the amount of saving and the rate of return that savers obtain are directly related. The amount of increase in saving that would accompany a given increase in the rate of return is not precisely known, although the evidence indicates that saving is more responsive to its rate of return than was generally believed to be the case a decade or so ago.

Congress seems to have recognized that the tax structure has some influence on the amount of investment. It has favored reducing the rates of taxation of capital income from specific fields of investment. Insofar as this has resulted in very little reduction in the average rate of taxation of capital income it has served largely to divert investment into the lower taxed areas from the higher taxed ones without increasing by very much the overall amount of capital. This diversion is costly to the economy as a whole in that in order to yield the same after-tax rates of return, investments must have different before-tax rates of return if they are taxed at different rates. For example to yield 5 percent after tax an asset must yield 10 percent before tax if its yield is taxed at 50 percent and 20 percent before tax if the tax rate is 75 percent. If the respective yields of 20 percent and 10 percent represent the contributions of these investments to the income of the economy as a whole, we should be shifting capital from the low before-tax fields to the higher ones. This equalization of rates before tax would be more or less the outcome of taxing all opportunities at the same rate.

The committee has expressed interest in the most "cost-effective" ways to encourage savings. I am uncertain as to what the committee considers to be cost. Congress seems to have been interested in minimizing the loss in tax revenue required to obtain a given amount of investment in a particular area and the result has been the "tinkering"—investment tax credits, accelerated depreciation for some investments, etc.—that I have just discussed and do not favor. If minimum loss of tax revenue were the appropriate criterion, introducing a tax based on expenditure and reducing rates on the income taxes would increase the incentive to save with no loss of tax revenue. I favor a criterion such as the present value of national income as the appropriate one for guiding tax policy, but both a larger present value of national income and more saving with no loss in tax revenue would follow from introducing an expenditure tax and reducing the income taxes.

An expenditure tax makes the amount of the tax depend upon how one disposes of his wealth rather than upon how he obtains it. Although administering such a tax would raise many problems, some of which probably have not yet been visualized, it would eliminate many of those now raised by our present system. For example, taxation of capital gains and foreign source income as well as the treatment of income that fluctuates widely over time would no longer be problems.

Although the committee has not asked whether saving can be increased by just reducing taxes rather than by changing the emphasis from taxing income to taxing consumption, let me say a few things about a tax cut. If taxes are reduced and expenditures are not, the amount of government borrowing or money issue must be increased. The Treasury doesn't print money to finance the deficit, but the Federal Reserve does when it buys the debt in the open market. If the debt is going to be paid in the future by such money issue rather than from tax collections, the difference between financing a budget deficit by issuing debt rather than printing the money now is not likely to be very great. The price level will end up at the same value, although its path through time may vary with the pattern of conversion of debt into money.

An important issue is by how much tax revenue will be reduced if tax rates are reduced and government expenditures are left unchanged. I have supported tax reduction because I believed that it would induce Congress to cut, or at least slow the growth in expenditures. However, there is now much talk about reducing tax rates with no change in government expenditures in the expectation of no fall or perhaps even a rise in tax receipts. If tax rates were very high, reducing them would increase revenue. For example, if an income tax rate of 99 percent is cut to 98 percent, after-tax income doubles. Although the effective rates on capital income are high, an increase of one dollar in GNP generates less than 50 cents of additional tax revenue. A cut of one percentage point in the tax rate adds about one percentage point to after-tax income.

A tax cut could result in some increase in taxable income if there is more production or if more income is reported for tax purposes. Lower tax rates reduce the incentives not to pay taxes legally due and to engage in activity that is not subject to tax. Also, in the short-run employment may rise, if the wedge between employers' costs and workers' after-tax pay rises. In the long run, there will be more capital and more capital income to tax. However, I cannot see anything except more inflation in the short run if taxes are cut significantly and the structure of Government expenditures is not touched.

Whether there would be more saving if more inflation is substituted for explicit taxation is not known. If more inflation would bring more saving, I would

not favor this method of obtaining a larger capital stock. If there is to be a substantial over-all tax cut and a halt to inflation, there must also be adjustments in Government expenditures so that the budget balances at about the level of GNP that could be produced in the United States with current prices and about 6 percent unemployment. Already a $60 billion deficit is projected for 1980. A major tax cut without expenditure adjustment will not improve the outlook for inflation.

To conclude my remarks, I will comment briefly on the possibilities of saving for retirement in a time of high inflation and the relationship between saving and growth and the U.S. Social Security System. Retirement benefits in the U.S. Social Security System are provided from the taxes levied against employed workers. The current generation of workers is paying the retired workers in the expectation that the next generation will pay the current generation when it retires. The amount that those who are retired can obtain from those who are working does depend upon the real earnings of the employed population. These, in turn, depend upon the capital stock which is related to the rate of saving. Increased saving now can make future benefits higher than otherwise would be the case. However, the level of benefits per retired worker depends not only on how much the employed workers are willing to contribute but upon how many retirees there are. This is dependent not only upon the age distribution of the population but also upon when workers retire. It is the growth in the ratio of retired persons to employed persons that raises the prospect of a "crisis" in Social Security. Benefit levels in the future probably cannot be as high as many expected, and a higher saving rate won't do much toward closing this gap.

If it is known that the rate of inflation will be a given number, contracts involving future money payments will be based on this rate. If the rate is not known, contracts can be made contingent upon the values which are taken by an agreed index, i.e., they can be indexed. I suggested earlier that income tax bills be made contingent upon a price index. Interest rates and tax schedules that vary with a price index are the rule in many countries that have experienced inflation—particularly in Latin America. However, Canada, Australia, Sweden, the United Kingdom, France, Luxembourg, Denmark and Switzerland have indexed taxes even though their histories with respect to inflation are more like that of the U.S. than those of Latin America.

The failure of the real retirement incomes of many in the U.S. to be as large as those who had saved for retirement had expected is because the inflation had not been anticipated. Few persons saving for retirement expected that the U.S. would become like a "banana republic" with double digit rates of inflation induced by the fiscal policies of its government. Most expected the value of money to be stable and they purchased financial instruments whose money values at maturity and rates of return were fixed and based on a dollar of a given value. Had they expected inflation they would have purchased physical assets or indexed contracts or have built the inflation rate into fixed nominal contracts.

Inflation imposes some real costs even when contracts are indexed. Things other than money will be used to perform functions that stable-valued money could perform more efficiently; bills will have to be paid more frequently and resources will be required to mark up prices on items in inventory. The capital stock will be larger and its productivity smaller than in an environment of no inflation. Consequently rates of return to saving in an inflationary environment will be lower than if the value of money were stable. Nevertheless, savers could hedge against inflation in ways that I have just noted.

Congress and the administration have not helped in the provision of anti-inflationary hedges. Controls over interest rates, wages and prices as well as resistance to indexing the tax structure are not consistent with helping people adjust to inflation.

Representative Brown. Mr. Boskin.

STATEMENT OF MICHAEL J. BOSKIN, PROFESSOR OF ECONOMICS, STANFORD UNIVERSITY, STANFORD, CALIF.

Mr. Boskin. Thank you very much.

Before I start, let me say that a word was left out of the title of my testimony. When I asked my secretary to take the long title and put

it on two lines, she left out the word "Saving." So it should read "Taxation, Inflation, Social Security, Saving, and Economic Growth."

Representative BROWN. Mere details.

Mr. BOSKIN. Second, I would like to take this opportunity to congratulate the Joint Economic Committee and its members and staff for the work they have done over the last few years in bringing a sense of balance to discussions of economic policy. It's the major place on Capitol Hill where long-term concerns about the economy are discussed, where the impact of sequential, sometimes willy-nilly, short-term policy proposals have been ferreted out against the long-term needs of the economy for healthy economic growth and I think that's something that's a great source of optimism to me about the ability of Congress to eventually get out of its short-term blinders.

I'd like to start by just stating a couple of statistics that are even more remarkable than those in the tables and the charts we have before us [indicating].

I'd like to take a slightly longer term view and that longer term view looks at the growth of real income per person in the United States over the last century.

It grew about 2 percent a year. Roughly similar growth rates were experienced in France and Germany. While there were substantial fluctuations about that rate, that has been an average over the last century. Late in the last century the United Kingdom was the wealthiest society on Earth, but it managed, by growing at 1 percentage point less than these other economies, to transform itself to that of a relatively poor member of the Common Market.

We're talking about a rate of real economic growth which comes close to doubling income between generations—not quite. We are about twice as wealthy over our lifetimes as our parents. In fact, if the growth rate is restored, our children will be approximately twice as wealthy as we are over our lifetime.

Since the early 1970's, that rate of real economic growth has slowed to a crawl. Real GNP per capita has been cut approximately in half—and we know it's not growing this year at all—but even this is an understatement of our poor economic performance because the major achievement of the 1970's was to put 18 million new workers to work, and if we look at a somewhat different measure, real GNP per employed worker—this would have some flaws since new workers are not quite as experienced and productive as existing ones—we didn't grow at all.

When I look at what has happened to the typical working taxpaying family, their economic condition has not improved since the early 1970's. I think that is a source of much concern about Government, transformation in the public eye of government as being the protector of the common or average worker to being a source of economic malaise for consumers and for taxpayers and for workers.

I believe that if we do not do something over a span of years to get our growth rate up to its historic level that we will experience consequences much more untoward than those of the recession we are experiencing now, and I do not think the social disruption and economic problems that will ensue from us being a very slowly growing

economy in the midst of a world where economies are growing much more rapidly would be very pleasant.

Certainly several decades ago when economies like France and Germany had per capita incomes much lower than that in the United States we had no right to expect to be able to grow as rapidly as they, but now that their per capita incomes are getting very close to ours it's clear if this performance continues we will soon be passed by by such societies and shortly thereafter by the Japanese.

Representative BROWN. Could you predict a date?

Mr. BOSKIN. By the end of this decade we will be passed substantially by the French and Germans if the growth performance of the last 7 or 8 years continues, and in the following decade by the Japanese.

So that's the first point I want to make.

The second point I want to make is that while the exact determinants of economic growth here as well as elsewhere are argued about by economists, there's genuine consensus that necessary conditions for economic growth per person are the accumulation of capital and—as Professor Eisner stressed, there are wide ranging types of capital, a point I will come back to in a moment—that requires a substantial real net investment and generating new technology or at least implementing new technology whether it's generated here or elsewhere.

Our recent performance on both those scores has been simply abysmal. Of our approximately $390 billion of gross investment last year, only about $40 billion of real net investment went into expansion of the capital stock to produce goods and services of a traditional type. The rest went into replacement, housing, pollution and safety control equipment, and the like.

Our rate of research and development expenditures as a fraction of GNP is falling. It's still somewhat higher than in countries we compare ourselves with most often, although their rates are rising.

More investment in my opinion will require increased funding availability and that increased funding availability in the long run in my opinion must come from increased domestic saving of one of several types, again a point I will come back to in a moment.

I think in the short run we could increase our investment by importation of foreign capital, but I think studies by Professor Feldstein and some theoretical conclusions I have come to suggest to me that it's unlikely that we are going to be able to finance a substantial increased rate of real net investment over long periods of time by increasing imports of foreign capital.

We need to provide the funds ourselves. Our low rate of investment has fallen off slightly. Our rate of saving has fallen off more. So although business saving has not fallen off very much, our personal saving rate has fallen off and another important form of saving and investment, that done by Government, has seen some very important changes.

By my own estimates, real Federal Government net disinvestment last year was as large as this $40 billion of real net private investment in plant and equipment and pollution and safety equipment.

Investment also can serve two other important purposes. One about which we know comparatively little but have rather startling implications if they are at all reasonable conjectures is new investment

which embodies new technology. It's very costly to incorporate old capital in the process of innovation and a substantial amount of learning by doing occurs. More cost effective ways of generating capital may be a difficulty from those points of view as well.

Saving not only provides us a vehicle for financing investment, but as mentioned before by everybody to my left at the table, it also provides a transfer of resources deviation from one period of life to another.

I would just like to point out that early in the next century when the post-World War II baby boom generation begins to retire and the recent baby bust generation is in the labor force full steam, as near as we can tell by the official estimates of the trustees of the Social Security Administration and advisory councils, the ratio of retirees to workers in our economy will go up by about 70 percent. At the same time we have been experiencing longer life expectancies than were expected earlier. A substantial increase in life expectancy of the elderly has been made since 1960 that was not predicted then and may well continue to occur in the future and an explosion in earlier retirement, so people are retired for longer periods and we're going to have a much greater ratio of retirees to workers in our economy early in the next century.

Think about what will happen if those people save a disproportionately low share of their lifetime income between now and the time they retire. Even our attempts to achieve a constant replacement rate—and I think that's a misnomer, but in the traditionally used sense of the term of social security—constant replacement rate leaves our social security with an immense deficit and even with that long-term deficit we would not be able to make up the difference in relative terms of this generation saving a much lower share of its lifetime income.

So the long-term saving problem is a dual one of helping finance the retirement and getting a better allocation of resources across individual lifetimes and also providing increased funding in the long run, a steady source and a reliable source of income funding in the long run to generate increased investment.

With respect to the social security deficit, I would like to point out that it's my own opinion that two points need to be made about social security.

Social security by providing an asset for individuals during retirement has been substituted for private saving. While somebody who is more of an expert on that subject than I is at the table, I recently was asked to do a short piece for the Joint Economic Committee's Special Study on Economic Change on that subject, and my own conclusion after evaluating all the arguments is indeed social security has over recent years, over the last several decades, led to a decrease in saving from what it otherwise would have been.

With respect to the long-term deficit, if we take a present value of already legislated taxes, including the 1977 amendments due to start effective in the 1980's and 1990's, and the present value of projected benefits on the assumption of the social security trustees there's a long-term deficit of approximately the amount of the privately held national debt. We're talking about tax rates to finance social security early in the next century before anybody pays a dime in individual income taxes at the State or Federal level on the order of 24 percent.

Currently we're paying around 12 percent and we will soon be up to 15 percent, but there's still an 8- or 9-percentage-point gap.

So I think social security has affected saving and one part is to refine the social security system. With respect to our longrun savings goals, I have tried to present in another paper a coherent framework for analyzing what the desirable or optimal saving investment rate ought to be and I conclude it's much, much higher than what we have been experiencing in the United States in real net terms in recent years and in a healthy noninflationary economy which is growing at a historical rate. I believe we are going to have to have substantially greater investment than we now have.

I believe there is substantial opportunity, as Professor Feldstein mentioned, to redesign our tax structure and accommodate our genuine spending needs while slowing the rate of growth of Government spending because of a particular confluence of events.

The first of those Professor Feldstein mentioned. That is, once we come out of this recession, hopefully some time next year, we have projected enormous revenue growth and beyond that necessary to keep Federal Government spending at its current rather high level of GNP. Just stabilizing that share of spending in GNP will not only allow us to adjust current programs for inflation but to have modest expansions of existing ones and major new ones over the years.

Excessive revenues, by the best estimates that I can come up with and see, in the Government over the 5-year period starting in 1982 from the bracket creep in the income taxes, the net revenue from the windfall profit tax which I will remind the committee that the House and the Senate conferees suggested overwhelmingly be returned in bulk by phased-in tax cuts to the general taxpayer, increased Federal Government royalties from land leases, social security tax increases, and so forth.

So the opportunity for revenue return to the general public and for major structural reform of the tax system will exist over the next 5 years.

Second, the opportunity to slow spending growth despite the possible need for increased defense spending also exists, but is not widely recognized in my opinion.

The tremendous growth in Government spending at the Federal level in recent years has been on transfer payments to individuals which now compose a substantially greater fraction of the Federal budget than do purchases of goods and services. But part of the reason that spending grew so rapidly is that programs which served genuinely noble and desirable social ends were not covering a large fraction of the population 20 years ago or 30 years ago, so part of the growth has been caused by extension of unemployment insurance coverage, extension of social security coverage, extension of a variety of overlapping antipoverty programs, for genuinely poor populations of the United States.

Well, it is not widely recognized because we still do our accounting in the same way we did when we generated the poverty index, but poverty has basically been eliminated in the United States. I know that's a startling statement. The official statistics tell us 11 percent of the U.S. population lives below the current poverty line. I'm not suggesting that that poverty line is a pleasant place to live nor that any-

body here ought to change places with them. When the original concept of the poverty line was developed, many in-kind transfer payment programs either were not in place or were very modest and only cash was counted. If we made any reasonable attempt to estimate a value on programs such as food stamps, subsidized housing, and so forth, we would come up with a percentage of the U.S. population below the poverty line of 3 or 4 percent. We will need to do something about them. The poverty line again is not a pleasant line to live at, but the era of tremendously rapid growth in transfer payments to help eliminate poverty in the United States in a broad historical sense has passed.

That doesn't mean those programs should be eliminated. I would oppose that. What it does mean is that the programs of the future will not require us to extend coverage of these programs to much more of the population and hence the programs need not grow as rapidly as they have and, second, that the major goal for such programs will be to increase their cost consciousness and getting income into the hands of the people who need it most and it seems to me this creates an opportunity, once we can get over the bitter rhetoric that surrounds discussions of reorganizing such programs, to slowing the growth of transfer payments by the Federal Government without causing any increase in hardship, indeed, while leaving us room to alleviate that hardship that remains. So, basically, that opportunity exists.

Our longrun goal, in my opinion, ought to be creating an environment of neutrality with respect to saving and investment decisions, something that Professor Eisner mentioned, and I think something Professor Eisner mentioned was that different types of assets were taxed very differently and he pointed out how important human capital, knowledge, experience, formal higher education, and so forth are in our economy—although our evidence on that is by indirection—but human capital is taxed very lightly. Indeed, investments in human capital are primarily financed out of forgone earnings. If you spend $3,000 or $4,000 to go to college you surrender an opportunity to have a job at $10,000, so the overwhelming bulk of those expenditures are financed out of forgone earnings. Since you never earn those earnings, they are never taxed. Human capital investment is taxed much more lightly than ordinary capital and I applaud Professor Eisner's discussion of different types of capital and Professor Brownlee's discussion about getting the before-tax returns into equality. In a paper to the Treasury several years ago, I demonstrated that neutrality does require expensing of regular capital and that expensing it turns out—I won't go through the rigmarole here—to move us to a system of expenditure taxes, and hence our longrun goal should be integration of the corporate and personal income tax and then switching from income to expenditure as a tax base. That will create neutrality with respect to investment incentives and to the consumption/saving choice rather than the current bias on balance in our tax system to spend today rather than to save for the future.

I would also like to indicate, while not being overly defensive about it, that it is my own opinion that recent econometric studies have developed which lent considerable credence to the ideas Professor Brownlee suggested—he kindly quoted my own work—that saving is responsive in the aggregate to the real aftertax rate of return. This tax system of gradually integrating the corporate and personal taxes

into an expenditure tax would substantially raise that rate of return over a span of time and substantially increase the aggregate saving rate in the U.S. economy.

I think that the important issue before us is how we get to that goal, a goal that was pointed out in an important Treasury Department document in 1977, "Blueprint for Basic Tax Reform," which lays out how to get to such a tax system, and I think the important thing is to make our short-term tax policy proposals and goals consistent with moving in the right direction.

There are a variety of things that would take us part way in that direction and then could be folded in when we finally made the complete step perhaps a decade from now—items such as gradually phased-in tax cuts, postponed until after this recession, are the direction to go. Creation of a universal individual retirement account for those individuals who do not qualify for one under current law would be an improvement, particularly younger workers who may only be partially vested in that pension but are prevented from having IRA accounts.

Eventual elimination of the taxation of interest and simplification and acceleration of depreciation I think all would move us in the proper direction.

I'm not suggesting we do all of those simultaneously, but I think all of those are sensible steps toward a neutral tax system which would—relative to our current system which discourages savings, because I wouldn't like to call these tax breaks—but actually the building of the disincentives with the combination of high inflation, high and rising effective marginal tax rates from income from investment and savings, have created this, especially in the last 10 years or so.

So I think all of those things are important. I should also like to indicate that it seems to me that getting the inflation rate down would do much in and of itself. The growth or acceleration of inflation and its insidious interaction with our tax system have been particularly severe.

I'd like to give you a simple but paradoxical example. Although Professor Feldstein pointed out the issues of historic cost depreciation and accounting procedures and other things in corporate taxes, even if the tax system did not have progressive rates, in an era of high inflation, the interest rates that have prevailed and the failure of our interest rate to completely adjust to the inflation to leave the aftertax rate of return unchanged, has led to a situation where even tax-exempt activities have been overtaxed.

Think about that for a moment. I don't know if you own any tax-exempt State and local bonds, Congressman, both if you did—and a not uncommon return in recent times has been about 9 percent, and we had a 13-percent inflation rate last year—so holders of those bonds, which admittedly are mostly high-income people, suffered a real loss of 4 percent. They were not allowed to deduct that 4 percent against other income, but they suffered a real loss of 4 percent, and, hence, even though their tax was zero, they were overtaxed. They ought to, in a proper tax system that taxed real income, be allowed a deduction for the difference, and alternatively, there are people, by being allowed to deduct nominal interest paid, who have done well in inflationary times.

Let me conclude by saying that this set of partial proposals once implemented—and I won't repeat some of the things mentioned by other people—implemented gradually over the next few years could move us part way toward a sensible tax system. The reduction of inflation I think is primarily a matter of a sustained, continual, gradual rate of monetary expansion by the Federal Reserve and a fiscal policy that is one of, over long periods of time, approximate budget balance, to take some of the pressure off the Federal Reserve amid the public's displeasure at high interest rates when the Government has to borrow substantial amounts—in that kind of milieu, effective tax rates would fall substantially and the uncertainty about long-term saving and investment decisions would be reduced substantially and that scenario would lead to a U.S. saving rate substantially higher over the foreseeable future than exists today. I think failure to do so will continue us on the road to sluggish investment, sluggish capital formation, and accrual of too little resources for our ciizens for the future, whether that's to finance their children's education or to buy a home or to finance their retirement, and so forth.

Let me just conclude by saying all these problems are obviously interrelated, while we as human beings tend to more easily think about one thing at a time.

First, we ought to have a clear idea of where we want to wind up, whether that's in 1990 or 2000, in our tax system, in our general overall fiscal policy, and so forth, and I've outlined what I thought that is and I would like to see whatever policy proposals are made in the interim consistent with a movement toward that goal, moving in the right direction. I think that opportunity exists now. When I was somewhat younger—and I'm only 34 now—we used to describe our Nation, our economy, our people, with words like productive, resourceful, creative, and so forth, and I hope that we will be able to regenerate our economy and describe our economy that way in the not too distant future.

Thank you.

Representative Brown. Thank you, Mr. Boskin.

[The prepared statement of Mr. Boskin follows:]

Prepared Statement of Michael J. Boskin

Taxation, Inflation, Social Security, Saving, and Economic Growth

I. Introduction

In the midst of a substantial recession, and what is hopefully the crest of the worst inflation in the history of the United States, it is tempting to focus almost exclusively on our short-run economic problems. My own personal viewpoint is that we face an even more insidious danger to our economic and social well-being: Our very sluggish rate of real economic growth per employed worker over the last decade or more and its potential continuance in the future. Put simply, our growth performance in recent years has been simply abysmal, both by our own historical standards and relative to that of other advanced economies. Over the last century, the United States, as well as such other societies such as France and Germany, have seen their real GNP per capita, and per employed worker, grow at an average of almost 2 percent per year. While substantial temporary fluctuations have occurred in this rate, such an average was not only maintained over the last century, but if we look at the two and a half decades after World War II, real incomes grew even slightly more rapidly than at this rate. At such a rate, GNP per capita will approximately double between genera-

tions; that is, each successive generation will be approximately twice as wealthy over its lifetime as the generation which preceded it.

Since the early 1970's our rate of real GNP per capita growth has slowed markedly, to about half of its previous post-World War II level. But even this decline dramatically understates our poor economic performance for the period.

Since the 1970's was a decade of unprecedented labor force expansion, due to the combination of substantial increases in female labor force participation and the post-World War II baby boom generation moving into the labor force in unprecedented numbers, real GNP per employed worker has grown at a horrendous one-tenth of one percent per year since 1973. The latter figure compares to about 2.7 percent for France, 3.2 percent for Germany, 3.4 percent for Japan, and 1.6 for Italy. While it was probably unwise for us to expect to be able to grow much more rapidly than these countries decades ago when our standard of living was so much higher than theirs, it is becoming decreasingly plausible, that our sluggish growth performance relative to these countries can be explained by the now modest differences in the level of income per capita among us. To put the matter in perspective, if these rates continue, average income in the United States will soon fall behind that of France and Germany, and eventually that of Japan.

While the exact causes of our sluggish economic growth are a subject of some current dispute, the general outline of what has been happening is becoming clearer all the time: We have not been adding enough capital to our capital stock; we have not been generating enough new technology and embodying it in that capital stock; we have chosen, sometimes unwittingly, to pursue policies which impede our ability to produce goods and services for other ostensibly noble social ends; and we had the structure of our economy change substantially. For example, we have witnessed an increasing displacement of private economic activity by government economic activity; a changing age, experience and occupational mix of the labor force; a shift in output away from manufacturing towards services; a rapid expansion of government regulatory policies; and high and rising inflation and marginal tax rates on the return to saving and investment, and a declining rate of national capital formation. I have elsewhere[1] reviewed and evaluated some of these studies which try to pinpoint the exact cause of our recent productivity slowdown. What I would like to do in the remainder of this testimony is to state what I believe to be the central core of our problem, discuss very briefly several of its major components, describe what I believe our long-run policy goals ought to be, and propose several important short-run policy proposals which will move us in the proper direction.

II. THE NATIONAL SAVING PROBLEM IN THE UNITED STATES

Private saving is important for two reasons: It is a major form of funding available to finance new investment, and it is the way in which our citizens transfer resources from one part of their lifetime to another, especially from their peak earning years to retirement. By the first quarter of 1980, the personal saving rate in the United States was at a 30 year low and less than half of its average in the mid-1970's; and by way of comparison, it was a small fraction of that in Japan, France or West Germany. Our national saving rate has three components: personal, corporate, and government saving. While our personal saving rate has fallen substantially, business gross saving has remained relatively constant; Federal government dis-saving has increased substantially; and state and local government (as the official statistics measure it) gross saving has increased somewhat. Overall, our rate of gross saving has fallen slightly in recent years relative to the 1960's and early 1970's. However, it is important to point out a variety of factors which have occurred in our economy which could and perhaps should have led to a substantial increase in saving over this period and hence, the modest decrease in saving should be viewed properly in my opinion as quite alarming.

First, there has been an enormous change in the economic environment, and demographic situation, facing current and future elderly persons in the United States. A major reason for saving, as mentioned above, is to provide resources to maintain standards of living during retirement. Since 1960, life expectancy of the elderly population of the United States has increased substantially, while at the same time, there has been an acceleration of the explosion in earlier retire-

[1] See M. Boskin, ed., "The Economy in the 1980's: A Program for Growth and Stability." Institute for Contemporary Studies, 1980.

ment. Only one male in five over the age of 65 is still in the labor force; more people now collect their first social security check at age 62 than at age 65. My own best estimate is that the average length of retirement period has increased about 30 percent.[2] By itself, this should have led to a substantial increase in private saving for retirement. In part, at least, it appears that this incentive has been offset by a substantial expansion in coverage and level of social security benefits. Since social security benefits are financed on a pay-as-you-go basis, whereby the current benefits received by retirees are financed by the current taxes paid by workers, no real capital formation occurs with this form of financing social security; if, indeed, this substitutes for private saving as many commentators have suggested,[3] it would seriously affect our overall saving rate. While the exact magnitude of these offsets is difficult to determine, and there is some controversy at the moment among professional economists as to the importance of this effect, my own belief, expressed in my study for the JEC Special Study on Economic Change[4] is that there has been a substantial social security offset for private saving in the United States.

A second reason to worry about a non-increasing, let alone decreasing rate of private saving, concerns the changing age structure of our population. Because of the post-World War II baby boom generation, and the recent baby bust generation, early in the next century, the ratio of retirees to workers in our society will increase substantially. If we continue to experience this lengthened retirement period (or see it lengthen still further), and continue to experience very low rates of private saving, the baby boom generation, when it retires, will show up at retirement ages having saved a disproportionately low share of their lifetime income relative to previous generations of retirees, and thus will be thrown relatively more heavily on other sources of retirement income support such as social security. As is well-known, the social security system already faces an immense long-term funding crisis even if current relative replacement ratios are maintained, let alone increased to offset low private saving rates over the years to come.

Thus I conclude that a substantial increase in the rate of private saving in the United States over the long-run is important quite independent of its role in helping to finance investment. But this second major purpose of private saving should not be ignored.

While our national rate of gross investment has not fallen quite as much as our gross saving rate, we have in part financed the differential by substantial increases in our importation of foreign capital. While in the short-run this will help us keep our rate of investment and capital formation from declining still further, it is not providing our citizens with claims to assets which can be transformed into retirement consumption later on. Further, it is unclear how long an advanced economy like the United States can continue to finance a major fraction of its investment by importing capital. While few would object to the notion of there being a substantially operative world short-run capital market, most of the success stories of economies growing by importing capital to finance investment have been those economies which were immature in the economic sense relative to their times: the United States and Canada in the last century, many less developed countries today, etc. History has not always been kind to those advanced economies which have failed to finance their own investment opportunities out of their own saving.

Elsewhere, I have tried to set up a framework for analyzing what an optimal or socially desirable real net rate of saving and investment, or capital formation, would be for the United States.[5] While that analysis is too complicated to repeat here, suffice it to say that in comparing the opportunities for increasing future standards of living by increasing our rate of capital formation today and foregoing some current consumption, appear to substantially outweigh these costs. My figures suggest that we ought to be saving and investing in real net terms substantially more than we have been for many years. Indeed, it is unclear that we added anything to our ability to produce goods and services in 1979. Of our

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[2] See M. Boskin, ed., "The Crisis in Social Security," Institute for Contemporary Studies, 1977.

[3] M. Feldstein, "Social Security, Induced Retirement and Aggregate Capital Accumulation," Journal of Political Economy, 1974.

[4] M. Boskin and M. Robinson, "Social Security and Private Saving: Analytical Issues, Econometric Evidence and Policy Implications," in Jt. Econ. Comm., U.S. Congress, "Special Study on Economic Change," in press.

[5] M. Boskin, "Some Issues in Supply-Side Economics," Journal of Monetary Economics, forthcoming.

$386 billion dollars of gross private investment, once we subtract replacement of our wearing out capital stock, residential investment, and anti-pollution and safety control equipment, real net private investment amounted to about $40 billion dollars. My own estimate suggests[6] that real federal government disinvestment was approximately as large. Therefore, I am deeply concerned about the prospect of continuing our low rate of capital formation in the years ahead. I believe that accelerating that rate of capital formation is a necessary condition for restoring our reasonably rapid rate of real economic growth and gains in standard of living of the average American; and that increasing that rate of real investment will must involve increasing our rate of saving from our own resources.

III. WHAT CAN BE DONE TO INCREASE SAVING?

Private saving decisions are primarily influenced by several factors: The prospective returns as measured by the after-inflation, after-tax rate of return to saving; the potential risks involved; age structure, family structure, and the milieu in which economic decisions are effected by government programs, such as social security.

Our tax system taxes the return to saving and investment approximately twice as heavy relatively as do those of Western Europe. We rely very heavily on taxes on income, with some notable exceptions, and these taxes tax saving twice: first, when it is earned as part of income and then when it earns an interest return. There is now a growing body of evidence, some of my own as well as that of other people,[7] that suggest that private saving decisions are much more responsive to the real after-tax rate of return than was previously supposed. This in turn implies that our heavy taxation of interest income seriously impairs private saving decisions. While it undoubtedly influences the form of saving, because of our comparatively lighter taxation of some saving vehicles than others, high and rising effective marginal tax rates on the return to saving have obviously been a major contributor to our low rate of saving.

Second, our high, and until recently rising, inflation rate has decreased private saving incentives for two reasons: first, it adds substantially to the uncertainty involved in the expected real net rate of return to such saving: it also combines with our unindexed tax system to drive up the effective marginal tax rates on different types of saving. This problem is much more widespread than the commonly known "bracket-creep". Even with a flat rate income tax, the failure to allow a deduction to separate out the inflation component of interest, causes an over taxation of interest returns. A paradoxical example that demonstrates the point was mentioned to me by Professor George Break of the University of California: recently tax exempt bonds have been overtaxed! Think about that for a moment. The bonds are tax exempt. How can they be overtaxed? A not uncommon interest rate in recent months for tax exempt state and local government bonds has been on the order of 9 percent. But inflation has been running much higher than that. Therefore, the owners of these securities have been suffering real losses. Since they cannot deduct these real losses from their other income in computing their tax liability, they are being overtaxed even though their rate of tax is zero. It is clear that so long as either high inflation continues or our tax system continues unindexed, that this problem will remain and seriously retard private saving incentives.

Third, a variety of government programs have formed subsitutes for private saving, and some of these programs do not result in any real capital formation. The most important example is social security, and I shall not repeat here what I have said elsewhere on numerous occasions other than to summarize once again the view that social security, while undoubtedly playing an extremely important role in mitigating such economic distress, and while it must remain a cornerstone of our income security system for the aged, has had the unfortunate side-effect of impairing private saving incentives in the United States.

Fourth, our changing demographic and labor force structure and household composition have led to a variety of changes in incentives to consume and to save. While it may well be that in the next decade a modest increase in our saving rate will occur as the baby boom generation moves into their forties, an age at which saving rates tend to be somewhat higher than in the late twenties and thirties, it clear that we must have a substantial increase in overall saving just to remain even with respect to the relative future contributions to their retirement income of private saving and other sources.

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[6] See M. Boskin, ed., "Economy in the 1980's," op. cit.

[7] As discussed in M. Boskin and J. Shoven, "Issues in the Taxation of Capital Income," American Economic Review, 1980, Proceedings of 1979 Annual Meetings.

In brief summary, we have generated, usually in an attempt to achieve other goals, a series of obstacles to private saving, and therefore, capital formation and long-term increases in our standard of living in the United States. Among the most important are our high inflation, high and rising effective marginal tax on saving, and a variety of government programs substituting for saving. Unless we begin to reverse this tendency soon, we will see the already damaging consequences worsen in the years ahead. It is my belief that we need to encourage substantially private saving in the United States. Perhaps it would be more accurate to say we need to unravel the disincentives we have created for private saving in the United States. Let me now turn to some suggestions for doing so.

IV. LONG-TERM POLICY GOALS AND SOME SHORT-TERM INTERIM PROPOSALS

A good general guideline for overall economic policy with respect to saving would be to make the decision between saving and spending as neutral as possible. We have for many years, via deliberate government policies, and by some other policies which were designed for other purposes, continuously stacked the deck in favor of spending and against saving. These policies have included the high and rising effective marginal tax rates on interest income; the extremely high rate of inflation we have experienced in recent years; the interaction of high marignal tax rates and inflation; the growth of a variety of government programs which potentially substitute for private saving; and the failure to realize the crucial role of saving for our long-term economic well-being. In addition, there has often been a substantial short-term bias in government economic policy designed to encourage spending in the often mistaken belief that such spending would enable the government "to fine tune" minor cyclical fluctuations in the economy. Experience has indicated that such programs have as often been destabilizing as stabilizing for the performance of the economy and it is only in times of severe economic disruption that are sustained, over long periods of time, that the government appears to be able to take steps to mitigate these economic problems.

The goal of neutrality would be served by moving toward a tax system which taxed saving once, and not twice. While we have moved partially in this direction in several pieces of legislation recently, from IRA and Keogh accounts to the modest interest exclusion which will be introduced into the tax code next year, we still have a long way to go. Our ultimate goal ought to be to integrate the corporate and personal income taxes (for example, by treating retained earnings as income distributed on a pro rata basis to corporate shareholders) and then switch this integrated tax to a personal expenditure tax in which individuals would be allowed a deduction for saving of any type in an unlimited amount. There is a substantial intellectual case for doing so, and the 1977 Blue prints for Basic Tax Reform of the U.S. Treasury documents and elaborates many of the practical details of implementation. I believe that this type of tax system ought to be our goal by the end of the century. It would restore neutrality in the consumption/saving choice, increase the after-tax rate of return to saving, decrease the disincentives to save that we now encounter, and substantially increase the private saving rate. But a drastic move in this direction all at once is both undesirable and politically impossible. What is important is that tax policy over the next few years be consistent with a move in this direction. Among the important possibilities worthy of consideration are the following:

(a) A universal IRA account. This would extend inclusion in IRA accounts to million of workers who are not currently eligible.

(b) Substantial increases in the limits on current IRA and Keogh accounts and/or proposed new universal IRA account.

(c) Substantial extension of the interest exemption to a point where it covers the majority of interest received by the majority of American taxpayers. While the original exemption is an important first step in principle and will have an effect on some savers, it clearly is a rather modest amount and does not reach saving decisions at the margin of anywhere near all taxpayers and savers.

(e) Simplification and acceleration of depreciation;

(f) Partial corporate integration, (e.g., dividend relief);

(f) Tax-free rollover of re-invested capital gains.

A second and related set of proposals is obviously crucial for other reasons: get the inflation rate under control. Just doing this would substantially reduce the effective marginal tax rates on interest income we have been experiencing in recent years, reduce the uncertainty involved in saving and investment, and spur private saving and capital formation. The most important items here are

a sustained moderate rate of money supply growth by the FED and decreasing the rate of growth of federal spending and deficits.

Third, get Federal government dis-saving and dis-investment under control. While exact magnitudes are hard to come by because of a variety of accounting conventions, perhaps establishment of a separate capital account would be desirable in the budgeting process to reveal just how far our government investment has fallen off in recent years.

Fourth, a restructuring of social security with the twin goals of guaranteeing income adequacy in retirement for the low income part of the elderly population and putting the long-term future of social security on a sound basis is highly desirable. To do so merely by raising the taxes over the years ahead will leave us with tax rates for social security alone on the order of 23 or 24 percent or more of earnings before anyone pays a dime of federal, state or local income or other taxes. It is my own belief that the time has come to reconsider the role of social security and the overall income security system of the elderly, and to rethink the target retirement ages that are set either explicitly or implicitly in the structuring of our social security system. At a time when our population has rapidly shifted out of physically demanding and dangerous jobs, the life expectancy of the elderly has increased substantially, a large and growing fraction of our labor force is entering the labor force later because of greater college enrollment, it seems time to reconsider our traditional retirement age. Currently there exist a substantial number of disincentives to continue work in the social security system. These are undoubtedly designed to enable those who, for valid reasons, find it extremely difficult to continue to work to retire in a dignified manner. I believe this system can be reformed by continuing to provide adequate income to these persons in what is currently an early retirement phase, while gradually raising the age for full social security benefits for the non-disabled elderly by perhaps one month per year for the next 24 years. This would leave us with a target or normal retirement age of 67, without reducing the annual retirement benefits to any elderly person. This by itself would substantially eliminate the long-term social security deficit without requiring tax increases above and beyond the enormous tax increases already legislated in the 1977 Amendments and due to take effect in the 1980's and 1990's.

Finally, I have also urged a separation of the transfer and annuity functions of social security. The transfer, or income adequacy, function should be shifted to an expanded supplemental security income program, and the annuity, or earned entitlements part of the program, should be put on a fair actuarial basis for everyone, i.e., they should all earn a common rate of return and no issue of equity or fairness among alternative population groups should be addressed in this part of the program. Ultimately, it might also be desirable, to allow proof of private pension coverage above and beyond a certain amount to satisfy this part of the social insurance problem.

V. CONCLUSION

The U.S. economy has veered off course in the last decade and a half. The problem is ultimately tied closely to our severe inflation and current recession, but it is a much longer term problem than that. And much of the malfunction can be traced to man-made disincentives to produce income and wealth. Our major economic goal for the future must be to restore healthy, non-inflationary economic growth, and this can only be accomplished in an environment with a more stable, predictable and slower rate of monetary expansion; a slower rate of growth in government spending; and a concerted effort to remove disincentives that obstruct saving, investing, innovating, and working. Our major need is for a steady, coherent, coordinated, long-run series of policies and a general policy framework to achieve these goals.

Without deluding ourselves about the possibilities of rapidly reducing inflation or instantly promoting our rate of growth, we must begin to unravel the disincentives for capital formation that high inflation, high and rising taxes, and other policies have created.

Obviously the policies proposed above must form a package implemented steadily and continuously over a long period—certainly over many years, perhaps decades. The gains from doing so will be enormous: restoration of non-inflationary steady economic progress, and the substantially reduced social and economic tension among different population groups that ensues in a growing rather than a stagnant economy.

In brief, we must make a healthy, growing economy our primary domestic concern. A variety of disincentives have been built up over the last decade and a half

to stand as obstacles to our long-term economic growth. To promote our economic growth, an increased rate of national capital formation and innovation is necessary. In the long-run, the bulk of this must be financed from increased private saving. The increased growth that will result will allow a variety of other important social objectives to be met; increasing productivity will help us finance future social security benefits without raising tax rates more than currently contemplated; this in turn should allow more ample opportunity for leaving resources in private hands to generate further investment and innovation. The reduction of inflation will substantially mitigate these disincentives, and provide a much more stable environment in which people can save for a secure retirement.

We have the economic capability of reversing the downward trend of our economy. It is clear to me that the cost of not surmounting the obstacles to our own economic growth extend beyond our economic well-being and that of our children and grandchildren. They include the threatened loss of political, diplomatic, and military leadership in the free world as an important example set for the mass of mankind—living on the brink of subsistence, tottering between relatively free societies and dictatorship—becomes extinguished. Our economic success stands as an important symbol of the compatibility of free political institutions, free markets, and rapid economic progress. How we respond to our economic challenge may influence decisively the evolution of many of the world's other economic and political systems.

Representative Brown. Mr. Bailey, if you would make an effort to keep it as brief as possible so we will have some chance for questions.

Mr. Bailey. That's very easy, Congressman.

STATEMENT OF MARTIN J. BAILEY, PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND, COLLEGE PARK, MD.

Mr. Bailey. I'm pleased that the Senator reversed the normal alphabetical order of the testimony because that gives me an opportunity to summarize and recapitulate what the others have said. To be brief, as you suggest, means I will just emphasize those points that most deserve it.

I'm going to concentrate on three questions that are the heart of the questions put forward in the opening statement. How do taxes and inflation affect the incentive to save? How does personal saving affect economic growth? What tax changes deserve consideration to encourage savings?

You note these are points on which we have already heard a great deal from my colleagues. Nothing that I say will differ very much from what they have already said. I'll just run through some answers to those questions.

Individual and corporate income taxes plus State taxes and to some extent property taxes reduce the aftertax rate of return to saving and thus are disincentives to saving. The result of the reduction is that it slows capital accumulation and economic growth. The slowing effect is substantial.

In relation to that, inflation increases economic uncertainty, particularly in the turbulent period we have had in the last 15 years with accelerating inflation. It also induces households and firms to shift investments into some activities and out of others.

Finally, it increases the effective rate of taxation. All of these effects reduce economic efficiency and the last of those effects slows capital accumulation even further.

Total national savings consists of not only personal savings but retained earnings by corporations and, as others have remarked, it is reduced by the Government deficit. Total national saving as a whole

is responsible for about half of the growth of real GNP, because saving adds to the productive capital stock which is one of the sources of growth—it's not the only source. Of our total national savings, over half is personal savings. In the decade of the 1970's about three quarters of national savings was personal savings.

To move on to the third question, there are several ways that present tax disincentives against saving can be reduced or eliminated. The simple, comprehensive way to deal with the problem is to replace all present income and property taxes with a consumption expenditure or value-added tax. There are several less comprehensive steps that would move in that direction. One such step is greater liberality in allowing exclusion of savings from the personal income tax base, as is now done for most contributions to pension accounts. Another is the integration of corporation and personal income taxes into a single-tier system with continuation or lowering of personal income tax rates, preferably lowering them. Still another is more rapid depreciation, or even immediate writeoff, for all investment in depreciable capital, and parallel treatment for inventory investment. All these steps, singly or in combination, would increase prospective earnings from savings and so would induce higher national savings and accumulation.

Now I will elaborate a little more on these answers, particularly on the numbers involved. Before all taxes, the rate of return on saving and capital in the United States has averaged in the range from 10 to 15 percent per year over the past several decades. After all taxes, this rate of return has averaged from 6 to 8 percent. Under current tax law, without inflation, taxes take almost half the return to saving. The difference in incentive to save for retirement and bequest is enormous, because of the effects of compound interest over long periods.

If inflation were to continue at 7 percent a year, the proportion of the return to saving that is taxed away would average over two-thirds, lowering the aftertax rate of return to saving to the range of 3 to 5 percent.

Now to move on to some numbers about growth, over the past several decades real GNP has grown at an average rate of 3 or 3½ percent a year. Capital accumulation contributes over 1½ percentage points of that growth or about half of it. In per capita terms, the growth is less, but the contribution of capital is no less, so capital accounts for about two-thirds of the growth of per capita real incomes.

Now putting these two things together, the disincentive to save and the effect of saving on growth, has the following implications. In the past several decades the savings share of national income has averaged 6 to 8 percent in this country. Eliminating the tax disincentive to saving would increase this share about half if present estimates hold up after still further research. That is, if these estimates, which are primarily Mike Boskin's are correct, changing the tax law to allow the rate of return to saving to rise to its pretax level would increase the share of income saved into the 9- to 12-percent range. Economic growth would accelerate in step with that; the part due to capital would also increase by about half, that is, by about three-quarters of a percentage point per year. This acceleration looks small for 1 year, but cumulated over decades its effect would be enormous.

In the past 30 years, real income per capita roughly doubled, as Professor Boskin said. I figured it at a 110 percent increase. But with

the added growth of three-quarters of a percent per year that you could have if the taxation were changed to be neutral, the per capita increase over that 30-year span would be 160 percent. In the same time span real GNP has risen by 181 percent or almost tripled. With the added growth, the increase would be 249 percent. That is real GNP would have gone up three and a half times.

Now these numbers are higher than the testimony I gave to Senator Bentsen's subcommittee 3 years ago. That's because in the interim Mike Boskin's estimates have had a chance to become respectable so I have adopted them as principal estimates.

In a number of ways, Congress has shown its concern about economic growth and about the taxation of retirement savings. It has periodically liberalized depreciation allowances, reduced the corporation income tax, and broadened the special tax treatment of pension savings. It has also given some attention to the possibility of integrating corporation and personal income taxes. To eliminate the tax disincentive to savings, Congress would simply have to proceed further along the same avenues.

Integration of personal and corporation income taxes would be a big step forward. If that's rejected, then a simple alternative that does almost as much would be to allow immediate expensing or writeoff of all investment expenditure in depreciable capital, plus a shift to cash-flow accounting for inventories for tax purposes. The incentive effects would be approximately the same.

Another step forward would be a more uniform treatment of personal savings. It would be a simple matter to increase the number of options and to reduce the restrictions on tax-exempt pension funds and accounts, so that most personal savings would qualify. However, downpayments and mortgage payments on a home do not fit into this picture because the return to investment in one's home is already exempt from personal income tax. If you press that all the way to the limit, it becomes a consumption expenditure tax. An equivalent possibility is to replace the property tax and all income taxes with a value-added tax on consumption goods.

That concludes my summary of what everybody else has said.

Representative BROWN. Professor Bailey, thank you very much. I find your summary impressive and also the testimony we have had up to this point.

[The prepared statement of Mr. Bailey follows:]

PREPARED STATEMENT OF MARTIN J. BAILEY

Inflation, Taxes, and Saving for the Future

This paper deals mainly with three questions: (1) How do taxes and inflation affect the incentive to save? (2) How does personal saving affect economic growth? (3) What tax changes deserve consideration to encourage savings? I will start by summarizing my answers.

Individual and corporation income taxes, and to a lesser extent property taxes, reduce the after-tax interest rate or rate of return the saver can expect from his savings, thus giving him less incentive to save. As a result, these taxes reduce national savings and investment—they slow the accumulation of productive equipment and other wealth. Compared to a tax system without this disincentive to save, the slowing of capital accumulation is substantial.

Inflation increases economic uncertainty, induces households and firms to shift investment into some activities and out of others, and increases the taxation of

the yield from savings. All of these effects reduce economic efficiency, and the increase of taxation aggravates the reduction of capital accumulation.

Total national saving accounts for about half the growth of real GNP, by adding productive capital to the available stock; it accounts for almost two-thirds of the growth of real income (or real GNP) per capita. Of total national savings, well over half is personal savings; in the 1970's personal savings averaged about three-quarters of national savings.

There are several ways that present tax disincentives against saving can be reduced or eliminated. The simple, comprehensive way to deal with the problem is to replace all present income and property taxes with a consumption expediture or value-added tax. There are several less comprehensive steps that would move in that direction. One such step is greater liberality in allowing exclusion of savings from the personal income tax base, as is now done for most contributions to pension accounts. Another is the integration of corporation and personal income taxes into a single-tier system with continuation or lowering of personal income tax rates. Still another is rapid depreciation, or even immediate write-off, for all investment in depreciable capital, and parallel treatment for inventory investment. All these steps, singly or in combination, would increase prospective earnings from savings and so would induce higher national savings and accumulation.

I

Every tax that includes capital values or income from capital in its base reduces the return to saving and so reduces the incentive to save. Income taxes, property taxes, and estate taxes all have these effects. Before all taxes, the rate of return on saving and capital in the United States has averaged in the range from ten to fifteen percent per year over the past several decades. After all taxes, this rate of return has averaged from six to eight percent. Under current tax law, without inflation, taxes take almost half the return to saving. The difference in incentive to save for retirement and bequest is enormous, because of the effects of compound interest over long periods.

Inflation increases these tax effects by raising effective rates of taxation, especially on the income from capital. Besides pushing people into higher tax brackets, which affects all types of income, inflation reduces the real value of depreciation allowances and the real value of the cost basis used in calculating capital gains. The depreciation effect and the tax bracket effect are well known. It is less well known that by reducing the real value of the cost basis when an asset is sold at a nominal profit, inflation reduces or eliminates the privileged tax treatment of capital gains, and can even make the tax confiscatory. Through all these effects, inflation increases the proportion of the return to saving that is taxed away. At rates of inflation continuing around seven percent a year, as on the average they have during the past dozen years in this country, this proportion would rise to over two-thirds, lowering the after-tax return to saving to the range of three to five percent.

We could easily make the mistake of supposing that inflation has eliminated the real return to saving altogether, which if true would present a bleak picture for retirement savings. It is true that interest on savings accounts has been lower than the rate of inflation, so that the real return to such accounts has been negative; however, statutory limits on deposit interest and on yields on savings and loan accounts have held them down and made them unrepresentative. It is also true that typical investors in the stock market during the past fifteen years have had a zero or negative real return. However, nearly half of this country's assets are our homes and other real estate, whose prices have on the average risen faster than the rate of inflation. A person with a representative mix of investments in corporate shares, savings accounts, and his own home, all growing due to his continuing savings, has received a positive return, net of taxes and inflation, in the three to five percent range. Not everyone gets this average result, as there are wide variations by locality and by the person's choice of investments. During an inflation, all investments are risky.

II

Over the past several decades the real GNP of the U.S. has grown at an average rate of three to three and a half percent a year. Capital accumulation, adding to the stock of productive equipment, housing, and so on, has provided over one and a half percentage points of this growth, or about half of it. Per

capita real income has risen at the annual rate of 2½ percent, of which increased capital per person contributes over once and a half points, or nearly two-thirds of it. This capital accumulation is made possible by saving in all forms. Personal saving is more than half of the total, and even that understates its role. In planning their retirement and other saving objectives, households take into account all forms of saving that affect them. Social security taxes and prospective pensions enter this picture. Corporate retained earnings, which raise book values and generally result in long-term growth of share prices, also enter it, through the capital gains the household expects on its holdings of corporate shares. Hence the household looks at its pro-rata share of national savings in all forms, not just at what our accounting procedures happen to call personal savings. It is better, therefore, to think in terms of the contribution of all savings to growth, not just personal savings.

Saving responds to incentives, although the size of the response is only very approximately known. In the past the saving share of national income has averaged in the six to eight percent range in this country. Eliminating the tax disincentive to saving would increase this share by about half, if present estimates hold up after further research. That is, if these estimates are right, changing the tax law to allow the rate of return to saving to rise to its pre-tax level would increase the share of income saved into the nine to twelve percent range. Economic growth would accelerate in step with that; the part due to capital would also increase by about half, that is, by about three-quarters of a percentage point per year. This acceleration looks small for one year, but cumulated over decades its effect would be enormous. For example, in the thirty-year span between generations our per capita real incomes have increased by about 110 percent; with this added growth, the increase would be 160 percent instead. In that same time span, real GNP has risen by 181 percent; with the added growth, the increase would be 249 percent instead, assuming unchanged labor force growth.

III

In a number of ways, Congress has shown its concern about economic growth and about the taxation of retirement savings. It has periodically liberalized depreciation allowances, reduced the corporation income tax, and broadened the special tax treatment of pension savings. It has also given some attention to the possibility of integrating corporation and personal income taxes. To eliminate the tax disincentive to savings, Congress would simply have to proceed further along the same avenues.

Integration of personal and corporation income taxes would be a big step forward for two reasons. First, it would lower the tax share of the return to savings. Second, it would reduce the tax distortion of resource allocation between the corporate and other sectors of the economy. Some investigators say that implementation of this proposal would be extremely complex, and that partial measures would have unpredictable and perhaps perverse effects. If so, a simple alternative is to allow immediate write-off of all investment in depreciable capital, plus a shift to cashflow accounting for inventories. Although this alternative would benefit non-corporate business whereas integration would not, the incentive effects would be approximately the same.

Another step forward would be a more uniform treatment of personal savings. It would be a simple matter to increase the number of options and to reduce the restrictions on tax-exempt pension funds and accounts, so that most personal savings would qualify. However, down payments and mortgage payments on a home do not fit into this picture, because the return to investment in one's home is already exempt from personal income tax. (Ideally, property taxes would be replaced and the tax treatment of owner-occupied homes would be brought precisely into line with the tax treatment of other capital. We pay a penalty in lost efficiency, lowered real incomes, and reduced growth for the present tax favoritism toward home ownership; the homeowner pays for the privilege of tax deductibility of mortgage interest and tax exemption of the rent-free services of his house by receiving a lower after-tax real income from all other sources. It's no bargain for him.) Carried to its logical conclusion, this approach leads to the uniform exemption from personal income tax of all savings (or of their returns), that is, to a personal consumption expenditures tax. An equivalent possibility is to replace the property tax and all income taxes with a consumption value-added tax.

These steps could lead to drastic simplification of the tax code if they include elimination of the special treatment of capital gains. Exclusion of savings from

the tax base would mean that capital gains reinvested would have a rollover privilege and so would be excluded; every dollar not reinvested would be taxed as ordinary income, so that cost basis would never enter the calculation. Likewise, immediate write-offs for depreciable investment would provide a drastic simplification. Once we allow a concern for proper incentives and growth to replace pursuit of the will-o'-the-wisp of equity, the simplifying effects are breathtaking. Therefore the proposals along these lines are well worth considering, for their short-term benefits as well as their long-term implications.

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Representative BROWN. I have an opening statement which I wanted to be put in the record earlier, but unfortunately because my plane was late I did not get it in, and I would ask unanimous consent that it be inserted in the hearing record at this point.

[The opening statement follows:]

OPENING STATEMENT OF REPRESENTATIVE BROWN

The United States is adrift. We have drifted into another brutal and needless recession. We have drifted into falling income and falling hopes. We have drifted until we are pushed around all over the world. Our fuel bills are pushed sky-high by OPEC. Our exports are pushed out of foreign markets. Our U.S.-made automobiles are pushed off American streets and out of American showrooms by foreign imports. Our people are pushed into debt, out of work and into despair.

We are not a nation of quitters. These events are not due to a so-called "malaise" among America's workers, businessmen and savers. The fault lies with selfish, short-sighted, destructive government policy.

The fundamental trends that are pushing this country into long-run stagnation has been ignored far too long. Creeping regulatory paralysis, inadequate depreciation allowances and soaring tax rates have retarded the growth of savings and investnmet. They are crippling supply. This is the source of stagnation. Government responded with excessive money growth in a vain effort to inflate the problem away and gave us stagflation and recession.

It is time for a fundamental shift in outlook and policy. We must concentrate on growth. We must overhaul our tax system to reduce the tax burdens on savings and investment and encourage productivity and work effort. To free up the

resources for this program and to fight inflation, spending and money creation must be restrained.

This is the program which the Joint Economic Committee has been recommending for two years in its bipartisan consensus Annual Reports. This is the program which many of the witnesses here today recommended to this Committee in 1977.

These charts on the wall, which compare the low and falling U.S. savings rate to the healthy savings rates of other major countries and which show U.S. productivity growth lagging behind that of our trading partners and competitors, are not here for decoration. They are meant to imply cause and effect. We want to examine the cause, correct it and reverse the effect. That is the purpose of this hearing.

The matter is urgent. Behind those charts are real people and real suffering. Productivity has now turned down in the United States. This is not just due to the recession. Productivity has been falling for six quarters, after doing badly for seven years.

With poor productivity have come seven years of declining real average weekly earnings, while spendable earnings after rising taxes have fallen even faster. The American Drean is becoming a nightmare. It is time for the country to force the Congress and the President to wake up!

Representative BROWN. Senator Roth, I will be happy to yield to you for 10 minutes and we'll go back and forth for a while picking these brains as carefully as we can.

Senator ROTH. Gentlemen, I apologize for missing part of the testimony. I had to be down in the Finance Committee as well.

One question I'd like to ask you, Mr. Feldstein, is about your suggestion that we might make certain proposals effective in 1985 because that would cause no loss of income currently to the Federal Government.

One of my basic concerns is that Congress has the capacity to spend everything that it takes in and that we may be raising a false hope by saying we are going to take certain action in 1985. Instead, we'll find ourselves in the same posture we are today with respect to spending, so that we'll have to be "responsible" and have to once more push these tax measures further into the future.

I sometimes think the economists and people on the outside underappreciate the compulsion or whatever you want to call it to spend in Government. Unless we have the courage to leapfrog somewhere along the line I don't think we are ever really going to take steps to give any kind of tax relief.

Mr. FELDSTEIN. Well, I certainly understand your concern, Senator. My hope was that this kind of proposal would address just that concern; that is, by phasing in an explicit series of tax cuts the revenue forecasts for the next 5 years that are prepared for the Congress would indicate that there were fewer dollars there to spend and that would help to put a lid on the growth of Government spending.

I think if there's a difference here, it's a question of whether Congress first has to run the deficit in order to cut back on its spending in the next year or whether knowing that the revenue isn't going to be there because it precommitted itself to the tax cut is sufficiently strong. You're a better judge of that.

Senator ROTH. A second problem I have as a practical matter is that I personally am of the strong belief that we ought to try to lay out now our tax program for the next 5 years. This ad hoc piecemeal approach I think has partly created our problem. That's one reason we developed the Roth-Kemp proposal, to try to put some advance notice of what direction we're going.

Let me ask you this question. Under the current Roth-Kemp proposal, we do provide a 10-percent tax rate cut a year for 3 years, with indexing at the end of that 3 years. We also provide for spending restraint. As an approach, do you think that's sound?

Mr. FELDSTEIN. I think it's very sound. I think the 3 years, unless you're very successful in reducing the growth of the actual level of Government spending, may be too fast and that achieving the same thing over a period of 5 years would give you more scope for tax cuts for savings incentives rather than just aimed at bracket rate reductions.

Senator ROTH. I believe in your recent Wall Street Journal article you did say 30 to 40 percent over the next 4 years. So we can argue exactly how much.

Mr. FELDSTEIN. If you had a 30-percent tax cut capability over the next 4 years and you used all of that for bracket rate reductions, then you would have nothing left for savings incentives. If you stretched it out to 5 years, then I think you have the opportunity essentially to get the 30-percent bracket rate reduction and some of the important investment incentives and savings incentives.

Senator ROTH. Perhaps I'm wrong, but one of my concerns is that I don't think time is on our side as I look at the world's competitive situation. Have any of you gentlemen made any guesstimate or studies as to what kind of investment this country needs to become competitive in world markets again?

Mr. FELDSTEIN. I don't think that's a very easily answered question. I certainly haven't made such estimates. One of the other panelists—and you may not have been here—said basically that with floating exchange rates the balance of payments will balance. So in that sense we are going to be competitive no matter what we do.

At one level, that's a perfectly correct statement, but we may be a country that does nothing but export soybeans, and I don't think that ought to be the goal for our economy. I think that the structure of our exports will very much depend upon our policies, not only capital formation but regulation.

Senator ROTH. From a practical viewpoint, I think this country is the leader of the free world whose security depends upon our economy. I don't think we have any choice but to have some basic industries that are strong and competitive. So I really don't see how we can wait indefinitely. I think we have to take some pretty strong, vigorous action now if we're going to maintain our position of world leadership. I think events will overtake us.

Let me ask you. Part of the debate has been whether we should take action now or wait until next year. If we could know in advance where taxes are going to be—do you think that would have a beneficial impact on business and its decisionmaking? Do you think we would be better off knowing today what the tax picture was going to be next year and the following year?

Mr. FELDSTEIN. Sure. We could have a good tax cut within the next couple months. That would be better than doing it a year from now or even 6 months from now.

The only reason to wait would be that the tax cut that we could get in the short run was misdesigned and ill designed.

Senator ROTH. I'd like to ask the other members of the panel to comment on Roth-Kemp which has a 10-percent tax rate cut for 3 years, then indexing, and the first year would hold spending down to 20 percent.

Mr. EISNER. Senator, I'm sympathetic with the idea of programing tax cuts in the future. I would not want to hold myself precisely to 10 percent per year over 3 years. I would like to suggest, however, that we speak generally about cutting Government expenditures.

In the context of a discussion of saving, it should be realized that many Government expenditures do constitute a form of saving. It's just as much saving for the Government to finance the construction of an airline terminal as it is for a private airline to buy planes. Indeed, it may do more for airline service.

It's just as much investment to construct mass transit, public mass transit, to construct roads, as it is to have the private or business purchase of automobiles. I think we have to be careful in deciding which Government expenditures we want to cut. It has been pointed out that the great bulk of increase in Government expenditures has come in transfer payments, a great amount in social security payments. I think we have to face up very clearly, and not just say cut the Government expenditures. Do we want to tell the American people we want to cut social security benefits? I think there's a good point to have people work longer and not retire earlier but that's one way of cutting the growth of Government expenditures. Another would be the one big area of growth of real expenditures we foresee in defense expenditures and that may crowd out investment, private and public—crowd out productive investment. We have to face that.

In general, it's a complicated issue and I think simply to state that we want to cut taxes and cut Government expenditures is not necessarily going to add to the total of saving, let alone productive saving.

I could also just raise a quick question. In all the discussion of the high rates of taxation on saving, that private saving is undertaken in three ways. Personal saving certainly is in contributions to pension funds, private pension funds, and that is largely tax deferred at a very low tax rate. It is in the accumulation of equity in investment-owner-occupied housing, which is very lightly taxed, as I pointed out. And it is in capital gains and that is lightly taxed.

Again, we want I think not to toss around too easy notions of a huge rate of taxation on saving having in mind the poor sucker who invests in a passbook saving account or who saves by buying a Government saving bond. That kind of saving has a negative real rate of return, there's no question. But millions of Americans, perhaps not inappropriately, have had huge rates of return on their savings—certainly all of us who have bought homes over the last several decades.

Mr. BROWNLEE. Well, I have supported Kemp-Roth with the expectation that a responsible Congress would try to keep the ratio of taxes to GNP and expenditures to GNP approximately the same. You pointed out the Congress has the propensity to spend everything it receives. In fact, it seems to me it has the propensity to spend everything it receives plus 10 percent.

Representative BROWN. That's correct. I stand corrected.

Mr. BROWNLEE. The deficit is approximately 2 percent of the GNP and expenditures are a little more than 20 percent of GNP. So I would favor a program of tax reduction of the kind you have proposed, conditional upon maintaining expenditures in the long run at a level approximately equal to the amount of taxes.

Mr. BOSKIN. Senator, let me embed my answer to your question in some slightly broader concerns.

I think the Roth-Kemp proposal as currently constituted is certainly moving along the right direction. I think there is a great need in our economy currently and for the prospective future for a climate of fiscal certainty as well as a climate of monetary certainty. I think almost no other time in our history has been so bereft of fiscal certainty. A businessman trying to plan long-term investment not only has worries about financial markets and interest rates and fluctuation of inflation rates and the possibility of regulations changing in the midst of that, but there's very little notion of what the effective rate of tax would be. The same is true of private individuals in a variety of undertakings.

So we might quibble about whether the phase-in ought to be slightly slower or more rapid. The point I would like to make is there's a simple, fundamental equation that Government spending appropriately measured, which is much larger than that measured in the annual budget because of a variety of potential substitutes for direct spending, simply equal Government revenue in the form of taxes, plus the Government deficit, plus creation of money.

Now my problem with the original version of Kemp-Roth was that I was not sure that it would lead to the appropriate discipline on the spending side. I think many people were concerned about that. I share your belief that as deficits mount there will be a propensity to cut back spending as Congress gets embarrassed about the size of the deficit, but the deficit in any true sense of the term is the difference between what the Government is actually spending and taking in which is much, much larger than that officially reported. Since the 1974 Budget Reform Act, we have seen a substantial shift of activity off the budget and the net deficits of so-called off-budget items and federally sponsored agencies, like the student loan program, and so forth, add to this year's estimated deficit an amount equal to the $40 billion regular deficit.

My own estimate is that the Federal Government deficit is about $100 billion, not $40 billion. So I'm very concerned about getting all of that into a comprehensive budget statement which leads me to my major point which is that if we could indeed reduce spending as the current Roth-Kemp legislation suggests, gradually over a span of years, I would be delighted to support it unequivocably in its current state.

My major concern is how easy it will be to cut spending, and I suppose that my own feeling is that the movement has been so much in the opposite direction, for spending to expand—Federal Government spending is now about 23 percent of GNP, up from 20 or 21 percent a few years ago, and with the propensity of these enormous revenues to accrue that Professor Feldstein and I mentioned—and I know they are at the heart of your proposal trying to return the bulk of those revenues to the taxpaying public—we could easily see the

Government spending creep up another 2 or 3 percentage points. I would judge success by making sure that doesn't happen. I think I would be delighted if that doesn't happen, if we stabilize the 22 or 23 percent. I would like to see it cut. I think there is an opportunity to do it as a denominator—GNP—grows substantially and as we get the need for substantial transfer payments under control.

I think that the general idea is very well founded, something that I strongly advocate and support, and I'm delighted to have in place My sole reservation at the moment is whether we could really force those kinds of limits to spending growth.

What I fear is that the Congress will find ways to transfer direct spending into indirect spending by getting it off the books, off-budget activity, to mandate private activities—instead of a large national health insurance program, the proportions in one of your colleague's programs for what will be financed by the public, will be financed by mandated private activity, will change it and we'll mandate a lot of private activity which is almost like taxing and spending but shows up as gross health expenditures or pollution or safety control in auto sales.

What we need to do is find a way to deal with the total of all direct and indirect Government spending, not just direct Government spending.

So I think you're on the right path and I would just constantly point out that there are a lot of potential holes in the dike in Government spending that could be created and that is my major concern.

I would like to make two other points. One was about the rates of return on some forms of saving which are currently relatively lightly taxed. I think we would all agree as economists that net of risk and over long periods of time that the effective rates of return on all types of assets would equalize and hence even though some types of assets are currently lightly taxed—and you could point to examples of high rates of return on some types of saving, the very heavy taxation of the balance of saving leads to a reduction in the real aftertax, after-inflation return to all saving.

Second, Professor Bailey mentioned a value-added tax as a substitute for a personal expenditure tax. There are some differences that are just quickly worth noting.

Clearly, a value-added tax could be designed. So could a personal tax like our current income tax which allows people to subtract all saving from their income before they calculate their tax base. The value-added tax usually is levied at a relatively flat rate and would involve a new type of administrative apparatus to implement and also it turns out to be similar to a national retail sales tax in the final analysis, even though it's at each stage of production, and I guess I still have some Alexander Hamilton in me and would like to see sales taxes reserved for State governments and local governments; and in our system, quite unlike Western Europe which has much less of a Federal system, a value-added tax makes less sense.

Representative Brown. Mr. Bailey, could we have your response very quickly.

Mr. Bailey. In response to the question, I would prefer Roth-Kemp to doing nothing and I also prefer it to Professor Feldstein's proposal. I associate myself with the various caveats that we have heard from Professor Brownlee and Professor Boskin.

Representative BROWN. Let me pick up on the question, if I may, and ask whether or not at this point a tax cut that would target to savings, specifically, might be preferable to a broad marginal tax cut or a combination of those two things. Now we have proposed a combination of a tax cut at the margin of 10 percent and a stimulation for investment in the form of capital cost recovery in 10–5–3, but where would we put in our preference list a tax cut targeted to savings such as Mr. Feldstein has proposed or some of the other proposals in this area, either a reduction in the rate of taxation on earned income from investments or a reduction through increased exemption on savings income?

Mr. FELDSTEIN. I certainly would put it very high, in part because of concern about inflation. As I said at the beginning of my remarks, a stimulus to saving would make it less inflationary to stimulate investment at the same time.

Representative BROWN. In other words, to stimulate savings and to stimulate the investment through 10–5–3 would make a good combination?

Mr. FELDSTEIN. That's right.

Representative BROWN. Because you would expand the amount of savings and provide also an expansion of investment and the savings would be there for that investment?

Mr. FELDSTEIN. That's right. I think more generally that encouraging saving has a substantial advantage of beginning to offset the very adverse effects of inflation. The basic summary of all that the panelists have said about the way in which inflation has affected saving is that without inflation our current tax laws give half of the return from nonfinancial corporate investment to the Government and give the other half to the ultimate savers. The effect of inflation has been to cut the half that would go to the savers in half again, leaving the savers with only a quarter, and I think that has to be overcome.

Mr. EISNER. First, I would dispute that figure. I think that does not take into account the many ways in which people receive their return from savings. As I indicated, saving to a large extent takes place in capital gains and tax shelters and pension funds and owner-occupied housing and the like, which have been lightly taxed, if at all, and that saving has frequently been helped by inflation. But the direct answer to your question is I would very sharply favor general cuts in marginal rate of taxation to the extent that we are concerned with inflation, and I think we should be. There is a very important device for cutting taxes in a general way, in such a way as to be anti-inflationary, and that is cutting the payroll taxes, essentially social security. Under the current legislation social security taxes are going to rise over 1 percentage point on January 1. That is exactly the wrong way to go. It raises taxes. It raises cost to almost every employer in the country and thereby will raise taxes. That tax cut should not be allowed to take effect. In addition, you should find ways to cut payroll taxes and if you're concerned, as I'm sure the public is, about the social security fund, it would be a simple device to allocate funds from other kinds of taxes, from income taxes, for the social security fund. But the ideal way to go is to cut the rates.

Most of the public, if they really had their choice, would be delighted to say forget should all these gimmicks and just give us a cut

in the corporate tax rate and the personal taxpayer would say let's cut all tax rates whatever, 10 percent, and let it fall where it may. I think that is the way to proceed.

Mr. BROWNLEE. As far as capital income is concerned, it is being taxed at higher rates than other income. Yes, the proposal to reduce the rates of taxation on capital income without corresponding reductions in the rates of taxation on labor income I think makes sense. Let me indicate I'm in favor of the kind of proposal which Mr. Feldstein has suggested; namely, that we cut the marginal rate by 40 percent or whatever the number is, rather than by exempting another $400 or $300 or some such number of dividend and interest income. There are a lot of people already getting more in dividend and interest income than the amount which would be exempted, and such a tax cut would have no effect on them.

Representative BROWN. You're talking about tax cut on savings income rather than earned income?

Mr. BROWNLEE. Right, but I'm saying don't waste this tax cut by increasing from $200 to $400 or some such number the amount of capital income which is exempted from tax. This is not going to buy you very much, if anything, for the tax reduction which you grant.

Representative BROWN. How about dropping the tax rate on all savings to the lowest tax rate and in effect getting two separate incomes?

Mr. BROWNLEE. I'm a little afraid of this because it means a person with $25,000 of wage income and $25,000 of capital income will pay less tax than a person with $50,000 entirely of either wage or capital income.

Representative BROWN. How many people are there with $25,000 of wage income and $25,000 of investment income? Anyway, under current law, additional income is taxed at the highest rate and if you drop it down to be taxed at the lowest rate you do induce that person with the $25,000 income in wages to put a little more of his income into an investment or a little more of his income into a savings account.

Mr. BROWNLEE. This I understand. What I'm worried about are what would generally be considered inequities in taxes where two people with the same amount of income are taxed at effectively different rates. Schedular income taxation of the kind that's been proposed I don't think has been very successful in many of the countries in which it's been tried.

Mr. BOSKIN. Like Professor Feldstein, the way I would phrase it is removal of the disincentives that have accumulated willy-nilly over the last couple decades into saving incentives is at the top of my list of tax reform proposals. I think they can be integrated with a Roth-Kemp phasein general tax cut given the opportunities we will have with the revenues growth over the next few years and with any modicum of success at all about slowing the rate of growth of Government spending.

I'd like to reiterate a couple things my colleagues mentioned before. My own feeling is that a tax cut will not have or the types of tax cuts that have been suggested will not have a major impact on the current recession. I think by the time the tax cut is proposed and implemented it will have an impact on unemployment in this recession that is really not measurable. I think that what really is important is designing a senssible structural set of tax cuts and phased-in

tax cuts which provide a coherent and logical sensible tax policy and one that provides some probability of being coherent over a sustained period of time.

So I would have general tax cuts but gear a substantial fraction of them toward saving.

Mr. BAILEY. I would put special cuts targeted for saving definitely ahead of an across-the-board cut in taxes as a more desirable thing to do. I think I would put faster depreciation, preferably going to an instant writeoff, ahead of savings targeting for an income tax because the rapid depreciation approach would also reduce the distortion we have between the corporate sector and the noncorporate sector of the economy.

Representative BROWN. There would also be one other benefit and that is that you would get the greatest stimulation for investment per dollar of lost Federal revenue in acceleration of the depreciation, would you not? In other words, the tax lost is spread out over a number of years for the Federal Government, but the impact of that tax reduction in effect is to get an early expenditure of funds. Is that a fair statement?

Mr. BAILEY. Well, whether that's true or not depends on the details of the proposals. It's not automatically true. Targeting of the tax change in favor of savings could get the same punch depending on how it was designed.

Representative BROWN. You mean get the increase in savings without the tax loss to the Federal Government?

Mr. BAILEY. Right, the same bang for the buck.

Representative BROWN. In fact, a larger bang for the buck than a marginal tax cut?

Mr. BAILEY. Yes.

Representative BROWN. Let me address the problem of social security because it has been brought up. I got the impression from what Mr. Bailey said earlier that he feels that if we had an increase in growth, say three-quarters of 1 percent, that we might escape the pain of either financing social security payments from the General Treasury or financing social security payments by the necessity of increasing social security taxes. Would you all concur with that and could you give me the relative figure here as to how much we could hold down social security taxes by getting faster growth in the economy? What would be the balancing figure?

Mr. BOSKIN. In my forthcoming National Bureau of Economic Research paper, I have precisely laid it out as part of the paper. The numbers I come up with are that for each one-half percentage point you can stimulate productivity growth, the long-term deficit in social security will be reduced by approximately $100-plus billion.

A rough calculation would be about 19 percent of the much larger income. So that three-quarters of 1 percent increase in growth would allow us to decrease the necessary tax rate increases above and beyond those legislated already by several percentage points.

Mr. FELDSTEIN. I'm not sure whether I count that as a plus or a minus. I think the fact would remain that the social security tax payments, as Mr. Boskin said, wouldn't decrease, and there would just be bigger payments for given tax rates.

Representative BROWN. But you would not have increased rates of taxation.

Mr. Feldstein. I'm not sure whether that's a plus or minus for the following reasons: The same resources are being diverted away from capital formation into the social security system. One of the advantages of the rising tax rates that we foresee is that I think it's going to force the political process to slow down the growth of those benefits and allow people to finance their retirement through real capital formation, through the private pension system. and through direct personal savings like IRA's. Looking ahead, you said maybe tax rates aren't going to have to rise so much, therefore we won't slow down the growth of the social security system. In effect, that's wasting the opportunity to finance the same level of retirement at low contributions earlier in life through the real productivity of capital.

Representative Brown. Well, if you stimulate savings by the individual by whatever your tax cut method, and with the increase of savings you have stimulated growth of the economy, then don't you take the pressure off social security in two ways? You take it off in the macro sense. That is, you have more growth in the economy, therefore more people employed; therefore you can stabilize the tax rate and still have a strong social security system. But you also have provided that the individual will have been stimulated to establish some of his own savings and investment for his future retirement and you take the pressure off, in the political sense, from the individual who says, "I want more of my retirement years taken care of by social security." He no longer has to say that. He can say, "I've got my retirement years taken care of by my own personal savings," and therefore the pressure comes off social security to some extent. Would you accept that as an argument?

Mr. Feldstein. I hope that's right.

Mr. Eisner. I think we are talking at somewhat cross purposes. Any increase in taxes or contribution to private pensions which prevents people from consuming now, frees resources for investment as long as we have full employment. As far as the question of financing social security goes, that's really rather independent of the question of what benefits we can receive in the future. The more the economy grows, the easier it will be to support people in the future who are retired. The more people who are working in the future, the easier it will be to support them. Those things are really quite separate from the question of what the tax rates for social security will be and, for that matter. whether people contribute to retirement by contributing to a fund which the Government operates or contributing to a private pension fund. If they contribute the same amounts—and I hope Professor Feldstein would agree with me on this—it really doesn't make any difference whether instead of spending to buy consumer goods, they put money into a Government social security fund or into a private pension fund. His own arguments followed correctly—and I don't agree with him—his arguments are that the social security system discourages saving because people don't put into the social security fund system enough really to equal the present value of what they are going to receive as they would have to in a private pension system.

Representative Brown. Well, if I may summarize just for a minute, it seems to me what we have come to is the suggestion that we need a tax cut that would stimulate savings of a personal nature from which you draw the resources to modernize and expand the productive sector of the economy. Even Mr. Eisner suggested that if the Govern-

ment spending is done on infrastructure—things like airports and highways, whether it's new highways or the maintenance of the existing highways, or locks and dams or that sort of thing—we've made an investment in the capital improvement of the country. That's a Government investment, to be sure in most instances, but it is an investment. And we have to have savings to do that, both public and private savings. To do that, we need an across-the-board marginal tax cut to provide the resources to the private sector for that purpose, and at least a capping of the growth of the governmental expenditures so that we don't get badly out of bounds in terms of our expenditures and transfer payments at the Federal level as opposed to the revenue that the Government receives from the tax structure.

Mr. FELDSTEIN. In a sense, you don't have to provide extra resources to get much additional saving. The incentive effects are really what matter to saving, rather than the across-the-board tax cut. That is, if people are saving about 3 percent of their personal income, giving them another dollar in general tax reduction only adds 3 cents to their savings. You get very little out of that. Getting them to increase their saving rate from 3 percent to 4 percent is a one-third increase in their total saving. So it's the incentive effect, reallocation of their current income, that really matters for increasing savings rather than giving them more money in the hope that they will save a significant fraction of it. I think the reasons for a general tax cut are twofold—one to get people back more of their money, and the other to encourage effort and to reduce some the the distortion in job choice that exists because of our current situation.

Representative BROWN. Other comments?

Mr. EISNER. I would like to say some forms of saving are unproductive and shouldn't be bothered with. We have to watch that we don't increase one saving at the expense of another. The Congressional Budget Office no less, I note in its report, talks about productive investment, meaning business investment in manufacturing, and talks about investment in housing as being unproductive and commercial investment being unproductive. I think that's a judgment we should make. I think it's very productive for the American public to invest in homes in which they can live for their lives. That's about as useful a way of saving as anybody can think of. It provides for the bulk of people's needs in their old age and, as I said earlier in my formal statement and testimony, a great number of the proposals, well intentioned as they may be, are going to simply help some forms of saving at the expense of others and are hardly going to prove desirable or effective.

Mr. BOSKIN. I would just like to agree with your general summary and add that I second the point Professor Feldstein made that structural tax revision to render our tax system relatively more neutral between the choice of spending today and saving today, we have taxed investment incomes and saving in our economy approximately twice as heavy relative as do the Western Europeans, is really in my opinion the most important vehicle, and the most sensible vehicle for increasing the propensity to save by individuals for generating those extra resources for investment.

I'd also like to say that I think this is going to be a problem not just for this Congress, not just for the next one, not just for the next few

years, but increasing our rate of capital formation is going to be a problem for the next several decades and if we look at some of the other countries and implicit comparisons made about the recent growth performance of Germany and Japan, it wasn't one year's worth of extra investment that generated economic growth in those countries. It was a sustained, continuous effort. It was a setting of an environment where uncertainty was kept to a minimum, and where neutrality at least in Germany with respect to alternative types of investment, but certainly the disincentives and saving that have been built up in our country between inflation and high and rising marginal tax rates have not been experienced in nearly as great profusion there. We need to have that kind of a milieus and that kind of environment for a sustained, continued length of time. That's why I favor a gradual phasein of tax cuts, switch over to indexing perhaps eventually, and things of that sort, so people try to make decisions in their forties and fifties so they know what their retirement is going to be and can have some sense of fiscal certainty.

Representative BROWN. I think we have perhaps if not a consensus, at least a general pattern of support for the marginal tax cuts that are in Roth-Kemp. You mentioned indexing, which is also a favorite of mine and for an emphasis in tax cuts that would induce specifically additional savings and additional investment by the appropriate sector to provide for a more productive society. I think we could probably go on for the rest of the afternoon discussing whether or not we shouldn't also encourage specific items by tax approaches, such as R. & D. investment. Also, Mr. Eisner has mentioned housing and I know there are some specific proposals that would stimulate the housing market at this time, but it occurs to me that perhaps we have beaten the horse about as much as we can beat it without becoming unproductive.

I would like the opportunity, if I could, to submit some additional written questions to all of you with reference to some of those specialized areas. For instance, I'm curious to know about any comparisons between Japanese, German, and French treatment of corporate savings, investment, R. & D., and depreciation, so that we can get some background on some of those things that may be stimulating the other economies to grow faster than we are. The Joint Economic Committee shares the view of the panel that we need a plan for the long run, that we need not to look at countercyclical approaches of trying to get out of this recession which may in fact be coming to an end. It's a little hard to predict until we look back in that respect. Rather, we should build for the future of a soundly growing American economy that can resolve some of the problems that we have had, such as competitive problems for the United States with other nations, the funding of social security, and the right of the individual to have a home even though prices have gotten well out of hand over the last few years. If the way we recover from this recession does not cure those problems, we'll find ourselves not only in further economic difficulty abroad, but political difficulty and domestic unrest at home, because we have turned the American dream into a nightmare. I think all of us would like to go back to a happier American dream.

Do you have any further comments?

Senator ROTH. I would just like to make one comment, Congressman Brown. Sometimes I think we're talking out of the economic context, because if we don't provide any tax provision for next year it's the same as voting a tax increase. I think people are overlooking that aspect of it. It's not only true because of the social security tax increase, which I think you pointed out, but it's also true of our income tax as inflation pushes people into higher brackets. By inaction, we are voting for a tax increase. It seems to me the debate in the media overlooks that aspect of the problem. I'd just like to express my appreciation to each one of you for being here. It's been very illuminating, even though it's a little hard to follow sometimes. Thank you.

Representative BROWN. Thank you, gentlemen.

We will stand adjourned until the call of the Chair.

[Whereupon, at 12:15 p.m., the committee adjourned, subject to the call of the Chair.]