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TAX POLICY AND PRODUCTIVITY IN THE 1980's

#1067

HEARING

BEFORE THE

SUBCOMMITTEE ON TRADE, PRODUCTIVITY, AND ECONOMIC GROWTH

OF THE

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TAX POLICY AND PRODUCTIVITY IN THE 1980's

WEDNESDAY, JUNE 17, 1981

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON TRADE, PRODUCTIVITY,
AND ECONOMIC GROWTH
OF THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The subcommittee met, pursuant to notice, at 11 a.m., in room 6226, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the subcommittee), presiding.

Present: Senators Roth and Abdnor; and Representatives Richmond and Rousselot.

Also present: Bruce R. Bartlett, deputy director; Charles H. Bradford, assistant director; and Marian Malashevich, Timothy P. Roth, and Robert E. Weintraub, professional staff members.

OPENING STATEMENT OF SENATOR ROTH, CHAIRMAN

Senator ROTH. The subcommittee will please be in order.

The subject of today's subcommittee hearing is the effect of the Federal tax system on American productivity, industrial growth, and international competitiveness.

As we begin the hearing, I would point out that I believe our current tax system is headed in a dangerous direction that will cripple our economy unless we take immediate action. Over the last decade, inflation has pushed taxpayers into higher tax brackets, making it less profitable to earn more. Tax rates on extra earnings have risen very sharply for most taxpayers in the last few years. Indeed, the percentage of tax returns in or above the 25 percent tax bracket has more than tripled in the last 10 years. If nothing is done, it is estimated that virtually every family that now pays taxes—even those at the lowest marginal rate of 14 percent—will be in the top 50-percent tax bracket on their earned income by the year 2000, less than 20 years from now.

In my judgment, if these projections are correct, they will have a devastating impact on American productivity and competitiveness in the international market place.

American businesses are suffering, and the U.S. savings rate has fallen to 4.7 percent, the lowest percentage of diposable income saved since 1949. If the current tax rates continue to discourage real growth and saving, our economy will be increasingly burdened by inflation and unemployment.

Substantial personal tax relief is needed to provide employment, savings and investment incentives, which are essential to business expansion and increased productivity. An increase in personal saving will help finance both an investment boom and the Federal deficit, reducing the pressure on the Federal Reserve to increase the money supply. This will provide positive results in the fight against inflation.

The tax reduction proposed by the President is a comprehensive plan designed to cut marginal income tax rates and thereby increase both personal saving and investing on a broad scale. These cuts have the potential of increasing personal saving by $43 billion in 1982 and by $79 billion in 1984.

Three-fourths of the tax cuts will go to middle-income taxpayers—those who now pay most of the taxes. Under present law, taxpayers earning between $20,000 and $60,000 pay 72 percent of all income taxes. They will receive 73 percent of the tax cut benefits under the President's plan.

On the business side of the program, the accelerated cost recovery system is designed to reverse the tax bias against plant and equipment and to restore productivity growth in the United States to levels that we once took for granted.

One of the most pressing problems besetting American industry is capital formation, the process of raising cash to maintain and expand the productive capacity of the U.S. economy, its machinery, tooling, plant, and transport equipment.

In recent years, businesses have had great difficulty raising equity capital at reasonable costs. The prime interest rate is currently at a record level. And that means interest rates on borrowed funds are becoming more and more prohibitive.

Moreover, inflation during the past decade has compounded the problem; with spiraling inflation, businesses are being squeezed two ways: First, the money they are getting back in deductions is worth less each year. And second by the time business has recovered the cost of its investment, the replacement it must buy invariably costs far more. The result of this squeeze is that capital which should be recovered, renewed, and expanded is instead wasted. The greatest cure for inflation is improved productivity.

But there simply is not enough investment money available to meet industry's needs. Equity capital is expensive to raise, interest rates on borrowed funds are prohibitive, and industry simply cannot generate enough cash internally because of our outdated depreciation system. Industry is unable to modernize plant facilities and replace worn out machinery. This causes rising production costs, declining productivity, loss of jobs and a lowering of our standard of living. The situation threatens a lasting capital crisis that will have a severe impact on the U.S. economy.

The ability to recover capital over a realistic period has a direct bearing on the ability of the Nation's businesses to furnish goods and services to their communities, to provide new jobs, and to keep prices down through vigorous competition.

In my judgment, the accelerated cost recovery system will increase our productivity and offset wage increases, thereby restraining price increases. It will infuse billions of dollars into the economy by allowing all businesses to recover their investments in depreciable assets twice as fast as under current law.

Clearly, more needs to be accomplished if we are to get our economy moving again and back on the road to dynamic growth. We are therefore privileged to have with us today three distinguished witnesses: Murray Weidenbaum, the Chairman of the President's Council of Economic Advisers; Norman Ture, Under Secretary of the Treasury for Tax and Economic Affairs; and Charles Breecher, adviser on tax policy for the Republican National Committee.

Gentlemen, I'm delighted to have both of you here and I know that Mr. Ture will be here soon. I regret that we had to postpone these hearings from 10 to 11 because of a White House meeting which turned out to be canceled anyway, but that's the way the ball bounces.

At this time I'm pleased to welcome and call upon Senator Abdnor for any comments he may care to make.

Senator ABDNOR. Thank you, Senator. I'm going to forgo the opportunity to make a statement and I'm anxiously awaiting the testimony of our witnesses today. Thank you.

Senator ROTH. I would then ask you, Chairman Weidenbaum, if you would make your statement.

STATEMENT OF HON. MURRAY L. WEIDENBAUM, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. WEIDENBAUM. Thank you, Mr. Chairman and Senator Abdnor. I'd like to submit my full prepared statement for the record and just give the highlights if I may.

I welcome the opportunity to appear before this subcommittee to discuss one of the most troubling symptoms of our current economic problems, a pervasive slowdown and stagnation in productivity growth. This is a subject which has rightly been in the forefront of the concerns of the Joint Economic Committee for some time. As a matter of fact, my last contribution on this subject was a paper discussing the connection between productivity and regulatory reform which I prepared for the session that you, Senator Roth, chaired at the December 10 conference of the Joint Economic Committee.

The problem of productivity is closely linked to trends in the profitability and competitiveness of American industry at home and abroad. A reduced rate of productivity growth is an important contributing factor to the historically high rates of inflation that we have been experiencing. Stagnant productivity makes real wage gains for American workers increasingly hard to come by.

If we are to restore our economy to sustained and vigorous growth, with our industries able to compete successfully at home and abroad with foreign competitors, then we must employ the widest possible range of appropriate government policies. A comprehensive tax program of personal and business tax relief is essential.

If I may refer to my prepared statement now, as I have suggested there, there are causes of the slowdown that have been beyond our control.

The most important principle of productivity growth is that it is most encouraged by the unfettered operation of a competitive economy in an environment of stable government policy, free from frequent changes in tax and spending programs. Whatever increases uncertainty or reduces the freedom of markets or the competitiveness of business, whatever discourages the taking of risks, and whatever distracts the attention of workers and business from productive work is sure to cripple productivity growth. There are four key actions that are required to enhance the performance of the American economy.

First, we must restore a stable price level. Inflation is an insidious disease in a market economy. The smooth functioning of the economy depends upon the information that prices give to workers and to businesses. It tells them what is scarce, what is costly, and what is profitable. These are the bases for rational decisions. Once prices lose any reasonable degree of predictability, as they do during inflation, the message is lost. Thus, monetary and fiscal restraint make vital contributions to productivity by bringing down inflation and the accompanying high interest rates.

Second, we must reduce the burden of arbitrary and inefficient government regulation. Frankly, it is difficult to overestimate the explosive expansion of government involvement in private enterprise over the past 2 decades. These days all major aspects of the day-to-day operation of virtually every business firm must be carried out with one eye on Washington. This is a significant burden for large and established firms and it literally can be fatal for many small and innovative firms.

There are at least three major ways in which government regulations inhibit the growth of productivity. First, and most obvious, regulation diverts capital from more productive uses. It does this both by requiring particular processing that would not otherwise be done, and also by mandating that inefficient processes be used. But regulation also takes a more hidden and costly toll: it robs us of entrepreneurial and managerial talent. So much attention is devoted in discussions about productivity to the blessings of hardware. But machines and factories are only as good as the men and women who plan and manage them. Regulation diverts the time, attention and creativity of much of our best talent. This is not merely a question of the paperwork burden, though that is a real problem. Too much managerial talent has to be devoted simply to avoiding conflicts with the regulators.

Finally, a changing pattern of regulation creates uncertainty, and poorly conducted regulation creates instability. An environment of over-regulation generates concerns about what might be regulated next, and what retroactive obligations might be imposed in the future. Thus a climate of increasing regulation inhibits those who are not regulated as much as it does those who are regulated.

Third, we must restore a healthy growth of capital stock via incentives, and in my prepared statement I go into detail on that.

It is not merely the interaction of the tax code and inflation that has been a government-sponsored disincentive to invest. The Government's credit activities also play an important role. The Government deficit has to be financed by borrowing, raising interest rates in the process and squeezing out private borrowers. This is well known. But also, by giving preferential treatment to lenders through loan guarantees and other credit assistance, the Government is also pushing more productive ventures out of the capital markets.

Fourth, we must encourage the thrust that comes from R. & D. We have not done badly in this regard, but we could do much better. The problem is to provide the right incentives for human ingenuity. This is not something the Government can do. I was a civil servant myself for many years and I know from experience that there are many intelligent, skilled, and devoted people in Government service. But it is beyond the talents of any single group to divine the future. This must be left to the talents of all our people. If the right incentives are provided, they will respond—with no need for direction from Washington.

The administration's tax proposals provide many of the incentives necessary to encourage those creative talents and to encourage in other ways a restoration of productivity growth. First, the accelerated depreciation and investment tax credit proposals will promote investment in productive capacity and will contribute to reversing the decline in the capital-labor ratio, which I documented in my prepared statement.

Inflation has eroded the value of depreciation deductions in current law. By increasing the value of those deductions, the accelerated schedule offsets much of that erosion and provides a positive incentive to invest.

Second, we are proposing to liberalize the tax treatment of spending on research and development in two ways. Under current law, wages and salaries of researchers are expensed along with all operating costs, and my prepared statement goes into detail on that, but let me suggest one point that's overlooked. The proposed changes in the treatment of leased property will benefit firms who would otherwise not be able to take advantage of the accelerated depreciation proposals because they have no current or recent tax liability. Firms in this category include those in temporarily distressed industries. More importantly, for those concerned with productivity, these changes will help new firms that are more apt to create or embody the latest technology but that may show no profit in their early years.

In my judgment, too many Government policies are aimed at achieving excessively narrow goals. This is as true in productivity as in any other area. Too many programs have been proposed to stimulate particular kinds of capital investment or employment; too many suggestions have been made to encourage particular forms of saving; too many ideas have been floated for encouraging the growth of particular industries, markets, or areas. We, in this administration, take a fundamentally different view.

This administration, instead, believes in providing broad incentives so that each person will do his or her best, and in reducing obstacles so that each person can achieve his or her best. In so doing, productivity growth will be enhanced. Thus, the essential need is to restore incentives for creativity. For this reason we believe that the President's program of personal tax cuts is of key importance in solving the productivity problem. By lowering tax rates at the margin, prohibitive tax rates that now encourage unproductive work and unproductive investment will become a thing of the past. Rather than forcing productivity growth through one Government-selected channel or another, we believe that the people as a whole will invest their time, talents, and wealth in the most productive activities; those which the signals of a competitive market indicate are likely to yield the highest returns.

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To recapitulate, the most effective policy to encourage productivity is not a narrowly focused effort aimed at productivity itself. Rather, it is the creation of a healthier, more competitive economy which by its basic nature operates at higher levels of productivity. Boiled down to its essence, my suggestions for productivity encouragement are as follows:

One, reduce the heavy burden of taxes on the economy by prompt enactment of a comprehensive program of tax relief. The Reagan administration's tax program is designed to do just that.

Two, reduce the heavy burden of regulations on the economy. That means supporting our program of regulatory relief.

Three, reduce the heavy burden of inflation and high interest rates on the economy. That means supporting fiscal and monetary restraint.

The accomplishment of these objectives will generate the higher levels of R. & D., capital formation, efficiency, and entrepreneurial activity which are at the heart of productivity growth. Thank you very much.

[The prepared statement of Mr. Weidenbaum follows:]

PREPARED STATEMENT OF HON. MURRAY L. WEIDENBAUM

Mr. Chairman and members of the subcommittee, I welcome the opportunity to appear before this subcommittee to discuss with you one of the most troubling symptoms of our current economic problems, a pervasive slowdown and stagnation in productivity growth in the American economy. This is a subject which has rightly been in the forefront of the concerns of the members of the Joint Economic Committee for some time. As a matter of fact, my last contribution to the study of this subject was a paper discussing the connection between productivity and regulatory reform prepared for a congressional conference sponsored by the Joint Economic Committee only last December.

The problem of productivity is closely linked to trends in the profitability and competitiveness of American industry at home and abroad. A reduced rate of productivity growth is an important contributing factor to the historically high rates of inflation experienced over the past decade. Stagnant productivity makes real wage gains for American workers increasingly hard to come by.

If we are to restore our economy to sustained and vigorous growth, with our industries able to compete successfully at home and abroad with foreign competitors, then we must employ the widest possible range of appropriate government policies. A comprehensive tax program of personal and business tax relief is an essential element in achieving those objectives.

Let me begin with a short professorial overview. What do we mean by productivity growth? Simply put, we mean "producing more with less." For example, assume we can produce 500 widgets a day in a factory with 100 employees and two machines, and the managers replace those two machines with two new ones that enable those 100 employees to produce 750 widgets a day. As you can easily see, labor productivity has increased 50 percent.

Clearly, one of the objectives of economic policy should be to create an environment in which the acquisition of new and more productive machinery is an attractive proposition for business. And one of the most efficient ways to achieve this objective is with well designed tax policies which encourage the demand for investment and the supply of the savings to finance that investment.

Labor productivity—the amount of output per employee—is the most commonly cited productivity measure. But we can also measure productivity in terms of capital (machines, in this case) or in terms of the amount of energy consumed.

We can also lump together such disparate elements as labor, capital, energy, and raw materials and get a measure of "total factor productivity". This type of measurement, as you might suspect, is typically carried out by academic economists, who find it useful because it attempts to give us an idea of the economy's overall ability to produce efficiently.

When we are analyzing productivity trends in the economy over a period of time, there are serious measurement problems, which I do not need to review today. However, even allowing for problems with productivity measurement, our productivity growth has been extremely disappointing for over a decade. Labor productivity in the nonfarm business sector grew at an average annual rate of more than 2½ percent from 1945 to 1965. During the next eight years it grew at a 2¼-percent rate. Since 1973, however, productivity growth has fallen to under one-half percent a year. In fact, for the past three years it has actually fallen. A somewhat similar pattern also prevails when we look at total factor productivity.

It is instructive to compare this performance with trends in other countries. The Bureau of Labor Statistics has recently published data for manufacturing that allow us to do this (see table 1). They show U.S. productivity growing 3 percent annually, on average, between 1960 and 1973, but only 1¾ percent thereafter. While other major countries, including all our major trading partners, also witnessed slowdowns like ours, they were generally of lesser magnitude and from a higher base. For example, Japan showed gains of 10½ percent during the first period, and 7¼ more recently. Germany showed 5½ percent, followed by 4¾ percent. So, although we are not alone in facing the problem of productivity slowdown, our problem may well be a lot worse than those of many other industrialized countries.

TABLE 1.—OUTPUT PER HOUR IN MANUFACTURING, 11 COUNTRIES, AVERAGE ANNUAL RATES OF CHANGE, 1960–80

	1960–80	1960–73	1973–80
United States	2.7	3.0	1.7
Canada	3.8	4.5	2.2
Japan	9.3	10.5	7.2
Belgium	7.3	7.0	6.6
Denmark	6.6	7.2	4.4
France	5.5	6.0	4.9
Germany	5.4	5.5	4.8
Italy	5.9	6.9	3.5
Netherlands	7.4	7.6	5.5
Sweden	5.4	6.9	2.2
United Kingdom	3.2	4.1	1.4

Source: Bureau of Labor Statistics.

There is one important caveat to make about recent productivity growth. It is strongly procyclical. That is, labor inputs are not reduced proportionally when production falls, so productivity falls more sharply than output. Economists refer to this as "labor hoarding". This "excess" labor is put back to work when demand grows again, so productivity then grows faster than output. Because our economic growth has been so weak in recent years, part of the recent dramatic slowdown can probably be ascribed to this phenomenon. But, likewise, the most recent figures for the first quarter, showing productivity growth at an annual rate of 4.3 percent, do not mean that the problem has been solved. The recent good news is probably the result of the business cycle. The productivity slowdown in the United States is a long-term problem, and it requires long-term solutions.

CAUSES OF THE PROBLEM

There are two kinds of causes behind the productivity slowdown: those we cannot do anything about, and those we can do something about. Analysts differ on the magnitude of each of the major causes, and some feel that much of the slowdown still remains unexplained. But even if our problem were caused entirely by forces beyond our control, (which it isn't), we would still have the means to cure it. It is important to realize that even if lagging investment isn't the sole cause of the slowdown, boosting investment will still go a long way toward restoring growth. The same is true for reducing inflation, for eliminating the burden of government regulation, and for increasing research and development.

As I have suggested, there are causes of the slowdown that have been beyond our control. The post-war baby boom and changes in women's participation in the workforce have reduced the average level of experience of the workforce, a development that time will reverse. Oil price increases have caused businesses to substitute labor for energy when possible, and may have rendered large portions of our capital stock obsolete. Finally, changes in consumer demand toward services, where productivity is lower (and productivity changes are harder to measure) have also reduced productivity growth. But there is a great deal that public policy can do—and undo.

SOLVING THE PRODUCTIVITY PROBLEM

The most important principle of productivity growth, I believe, is that it is most encouraged by the unfettered operation of a competitive economy in an environment of stable government policy, free from frequent changes in tax and spending programs. Whatever increases uncertainty or reduces the freedom of markets or the competitiveness of business, whatever discourages the taking of risks, and whatever distorts or distracts the attention of workers and business from productive work is sure to cripple productivity growth. There are four key actions that are required to enhance the performance of the American economy.

First, we must restore a stable price level. Inflation is an insidious disease in a market economy. The smooth functioning of the economy depends upon the information that prices give to workers and to businesses. It tells them what is scarce, what is costly, and what is profitable. These are the bases for rational decisions. Once prices lose any reasonable degree of predictability, as they do during inflation, the message is lost. This is true particularly in long-term planning where interest rates and long-term contracts play such crucial roles. Thus, monetary and fiscal restraint make vital contributions to productivity by bringing down inflation and the accompanying high interest rates.

Second, we must reduce the burden of arbitrary and inefficient government regulation. Frankly, it is difficult to overestimate the explosive expansion of government involvement in private enterprise over the past two decades. These days all major aspects of the day-to-day operation of virtually every business firm must be carried out with one eye on Washington. This is a significant burden for large and established firms and it literally can be fatal for many small and innovative firms.

There are at least three major ways in which government regulations inhibit the growth of productivity. First, and most obvious, regulation diverts capital from more productive uses. It does this both by requiring particular processing that would not otherwise be done, and also by mandating that inefficient processes be used. But regulation also takes a more hidden and costly toll: It robs us of entrepreneurial and managerial talent. So much attention is devoted in discussions about productivity to the blessings of hardware. But machines and factories are only as good as the men and women who plan and manage them. Regulation diverts the time, attention and creativity of much of our best talent. This is not merely a question of the paperwork burden, though that is a real problem. Too much managerial talent has to be devoted simply to avoiding conflicts with the regulators. And, for that matter, I suspect that too much of our best talent is attracted today to the legal profession.

Finally, a changing pattern of regulation creates uncertainty, and poorly-conducted regulation creates instability. This is more than just not knowing how regulations will change from year to year, (though this certainly makes planning difficult and discourages investment). An environment of over-regulation generates concerns about what might be regulated next, and what retroactive obligations might be imposed in the future. Thus a climate of increasing regulation inhibits those who are not regulated as much as it does those who are regulated.

Third, we must restore a healthy growth of capital stock via incentives. A great deal had been written and spoken about this, so I will be brief. But, I do have some observations that I think deserve mention. First, the revised National Income and Product Accounts show that investment as a share of GNP has performed relatively well in recent years. However, because much of this investment was devoted to replacement and because much of it was of a short-lived nature (due, at least in part to inflationary expectations), this investment pattern did not translate into a comparable growth in the capital stock. Table 2 shows what this has meant for the ratio of capital to labor, a useful indicator of the ability of investment to contribute to productivity:

TABLE 2.—THE INVESTMENT SHARE AND GROWTH IN THE CAPITAL-LABOR RATIO, 1949–79

Period	Real business fixed investment as percent of real GNP [1]	Percent change, average annual rate (end of year to end of year)		
		Net capital stock (nonresidential) [2]	Employment	Capital employment ratio [3]
1949 to 1959	9.1	4.0	1.1	2.9
1959 to 1969	9.8	4.6	1.6	3.0
1969 to 1974	10.5	4.2	1.2	2.9
1974 to 1979	10.3	3.0	3.1	−.1

[1] Average annual investment-GNP ratio, in percent.
[2] Net fixed nonresidential business capital, 1972 dollars, end of year.
[3] For private business, all persons. End of year calculated as average of year's 4th quarter and following year's 1st quarter.
Sources: Department of Commerce (Bureau of Economic Analysis) and Department of Labor (Bureau of Labor Statistics).

It is not merely the interaction of the tax code and inflation that has been a government-sponsored disincentive to invest. The government's credit activities also play an important role. The government deficit has to be financed by borrowing, raising interest rates in the process and squeezing out private borrowers. This is well-known. But also, by giving preferential treatment to lenders through loan guarantees and other credit assistance, the government is also pushing more productive ventures out of the capital markets.

Finally, let me emphasize that, even if investment were high and the capital stock continued to grow space, increasing investment would still be an appropriate means to restore productivity growth.

Fourth, we must encourage the thrust that comes from R&D. We have not done badly in this regard, but we could do much better. The problem is to provide the right incentives for human ingenuity. This is not something the government can do. I was a civil servant myself for many years, and I know from experience that there are many intelligent, skilled, and devoted people in government service. But it is beyond the talents of any single group to divine the future. This must be left to the talents of all our people. If the right incentives are provided, they will respond—with no need for direction from Washington.

The Administration's tax proposals provide many of the incentives necessary to encourage those creative talents and to encourage in other ways a restoration of productivity growth. First, the accelerated depreciation and investment tax credit proposals will promote investment in productive capacity and will contribute to reversing the decline in the capital/labor ratio. Inflation has eroded the value of depreciation deductions in current law. By increasing the value of those deductions, the accelerated schedule offsets much of that erosion and provides a positive incentive to invest.

Second, we are proposing to liberalize the tax treatment of spending on research and development in two ways. Under current law, wages and salaries of researchers are expensed along with all operating costs. This is itself designed to encourage R&D since all spending on research and development actually represents an investment for future production. We propose to encourage such activity even further by allowing a 25 percent tax credit for incremental spending on the wages and salaries of researchers. In addition, under our proposal the costs of all equipment and machinery used in research and development can be recovered in only three years. Comparable equipment not used in R&D would be depreciated over five years. Third, the proposed changes in the treatment of leased property will benefit firms who would otherwise not be able to take advantage of the accelerated depreciation proposals because they have no current or recent tax liability. Firms in this category include those in temporarily distressed industries. More importantly, for those concerned with productivity, these changes will help new firms that are more apt to create or embody the latest technology but that may show no profit in their early years.

Much that I have said has been said before. Indeed, many similar statements were made by past Administrations. However, I believe that today there is a very important difference, and it is currently an issue for debate. In my judgment, too many government policies are aimed at achieving excessively narrow goals. This is as true in productivity as in any other area. Too many programs have been proposed to stimulate particular kinds of capital investment or employment; too many suggestions have been made to encourage particular forms of saving; too many ideas have been floated for encouraging the growth of particular industries or areas. We take a fundamentally different view.

This Administration, instead, believes in providing broad incentives so that each person will do his or her best, and in reducing obstacles so that each person can achieve his or her best. In so doing, productivity growth will be enhanced. Thus, the essential need is to restore incentives for creativity. For this reason we believe that the President's program of personal tax cuts is of key importance insolving the productivity problem. By lowering tax rates at the margin, prohibitive tax rates that now encourage unproductive work and unproductive investment will become a thing of the past. Rather than forcing productivity growth through one government-selected channel or another, we believe that the people as a whole will invest their time, talents, and wealth in the most productive activities—those which the signals of a competitive market indicate are likely to yield the highest returns.

SUMMARY

To recapitulate: the most effective policy to encourage productivity is not a narrowly focused effort aimed at productivity itself. Rather, it is the creation of a healthier, more competitive economy which by its basic nature operates at higher levels of productivity. Boiled down to its essence, my suggestions for productivity improvements are as follows:

(1) Reduce the heavy burden of taxes on the economy by prompt enactment of a comprehensive program of tax relief. The Reagan Administration's tax program is designed to do just that.

(2) Reduce the heavy burden of regulations on the economy. That means supporting our program of regulatory relief.

(3) Reduce the heavy burden of inflation and high interest rates on the economy. That means supporting fiscal and monetary restraint.

The accomplishment of these objectives will generate the higher levels of R&D, capital formation, efficiencey, and entrepreneurial activity which are at the heart of productivity growth.

Senator ROTH. Thank you, Mr. Weidenbaum.

As you know, there are a number of proposals with respect to depreciation. The administration's business tax reduction proposal would allow all businesses to depreciate their investment in plant and equipment about twice as fast as is possible under current law. That has been criticized by some as being too generous.

On the other hand, we have an alternative being proposed in the House that would allow full expensing of business investment and equipment plus a phased-in reduction of corporate income tax of the current 46 percent top rate to 33 percent by the year 1990.

I wonder how you think these two proposals stack up? Which will do the most to help productivity? What are your thoughts?

Mr. WEIDENBAUM. Quite clearly, Mr. Chariman, I believe that the weight of professional opinion is that direct incentives for investment such as the 10-5-3 will do far more to increase investment than general reductions in the corporate tax rate. That's my response to your second point.

To the first point, I think you indicated the problem there. There is a range of suggestions, some less generous than the 10-5-3 program, some such as expensing that are more generous. The administration has struck a balance between the compelling need for providing additional incentives to economic growth and the compelling need for budgetary restraint. In addition, expensing would involve greater revenue losses. So I'm a strong supporter of the administration's position, because I think it represents striking the proper balance.

Senator ROTH. A lot of people indicate that they don't believe the United States can again become competitive; some of the basic industries—steel, the metals, even automobiles—have moved from our shores to not only Japan but newly developing countries, industrialized countries; that it's impossible for us really to compete with those countries partly because of the lower labor costs, but some say they have a higher degree of work productivity.

Do you agree with that or do you think the United States can again become a leading supplier of steel and other products and compete in the world market?

Mr. WEIDENBAUM. First of all, mine is not a counsel of despair. When I look at the whole range of industries, I think we have many that far more hold their own in world markets. We are still far and away the largest exporter in the world and certainly overwhelmingly the largest exporter of industrial goods.

Now, individual industries in this country have been facing specific problems, sometimes problems of government regulation which affect industries unevenly, sometimes perhaps problems of their own decisionmaking; a failure to properly control costs. Sometimes the government has provided wrong signals, such as keeping energy prices artificially low for decades, which I think is part of the problem that the automobile industry has faced.

But by and large, I think our industries are competitive and general purpose programs such as tax reductions and regulatory reform are far more appropriate than specially targeted assistance which, frankly, will only delay the time when our industries will be more fully responsive to competition and market forces.

Senator ROTH. In the area of regulation, particularly with respect to environmental matters, it's my understanding that Japan really has done a better job than we have in cleaning up the environment. My understanding is that this is due to the fact that they replace their plants on an average of every 15 years and they include equipment that has the lastest environmental controls.

Here, for example, we understand that, in the steel sector, 17 percent of new investment in the seventies was spent each year to comply with regulatory requirements, often trying to make old plants meet these new requirements.

I happen to be one who believes strongly in clean air and clean water. How do we reconcile our goals of clean air and clean water and yet do something about productivity?

Mr. WEIDENBAUM. I think the first step is to recognize the multiplicity of goals so that we view clean air and clean water as important goals, but our economic goals equally so. So that, very frankly, it's my concern—and I have been expressing it for some time—that when the Clean Air Act is renewed and extended, which I hope and trust and expect will be later this year, that the Congress takes economic concerns into account to a greater degree than it has in the past.

The administration is busy at work right now putting together its recommendations and, very frankly, I can't be more specific than that. But the most generous of tax incentives will not be sufficient if the regulatory barriers are extended.

I think it's an important effort. Sensible regulatory relief is really important so that more of the investment funds of American industry can be devoted, as you indicate, to new plant and equipment which generally is far less polluting than the old plant and equipment that it replaces. And here, the economic and social requirements need to be brought together and balanced much more satisfactorily than has been the case.

Senator ROTH. Well, my 10 minutes are up. I will call on Senator Abdnor.

Senator Abdnor. Thank you, Mr. Chairman.

Tell me, Mr. Weidenbaum, has productivity been greater or lesser in the small business area versus the larger?

Mr. WEIDENBAUM. Senator, I have not come across overall statistics on the subject. My instincts tell me that some of the major advances in productivity have been made by small, high technology companies that have pioneered in new technology which have generated new products, the new processes, which are at the heart of productivity growth. So that small business certainly is a very important factor in productivity growth.

Senator ABDNOR. I can't recall the source of information but I've heard that the majority of the new job creation has been in the small business field. Is there any basic reason why that might be occurring more in small business than in large business. Might it be that they are less affected by regulation or other factors?

Mr. WEIDENBAUM. Well, not really. If anything, small business tends to be harder hit. I think part of the thing is that large companies tend at this point to be positioned primarily in the mature industries, the slower growing industries, and the successful small companies are precisely those that penetrate the newer, more rapidly growing markets.

Senator ABDNOR. Then they can adapt?

Mr. WEIDENBAUM. They have more flexibility.

Senator ABDNOR. I know there is one overriding issue affecting small businesses in the rural parts of America and probably in every part of America as well. It is as important as what you were talking about—regulations and the like. It is the current high interest rate problem. Financing credit is the biggest single problem where I come from, which is a far cry from where my chairman comes from. There's just no way in the world that farmers and small businessmen can expand and become more productive when the cost of credit is prohibitive.

I would like to focus on agriculture because of its importance to my State. For example, cattle feeding is big business. An operator must invest hundred of thousands of dollars annually, and at the current market rate of interest there's no way they can make it.

Increasing productivity is necessary and important and I support efforts to promote productivity growth, but with high interest rates, our efforts will not be effective.

Mr. WEIDENBAUM. It's my understanding, Senator, that the high inflationary expectations are the driving factor for the high interest rates. As we continue to bring down the inflation, interest rates should fall. We have already seen the beginnings of at least a temporary and hopefully a longer term decline in interest rates. I can't give you a pinpoint forecast, but it is my expectation that as the inflation continues to unwind—because of the monetary and fiscal restraint that we have embarked upon—we will see inflation coming down and continue to come down, with inflationary expectations coming down, and further progress in bringing down those painfully high interest rates, which is our objective.

Senator ABDNOR. I like what I see and what you're trying to do, but why does Wall Street have so much uncertainty to it? What's their big fear?

Mr. WEIDENBAUM. Well, several factors. First of all, they have been burnt very frequently in the past by administrations who promise one thing and deliver something else. But one thing I can assure the members of the subcommittee of is that Ronald Reagan's administration is determined to stay the course. We are going to follow the policy of economic restraint to deal with inflation and economic growth to deal with the unemployment situation simultaneously. We are determined to bring down this inflation which is the heart of the high interest rate problem. Every action the President has taken since he's assumed office, I think, bears out that he is a man of great determination.

Senator ABDNOR. There is some indication that it's happening already.

Mr. WEIDENBAUM. Yes. I'm pleased to note that.

Senator ABDNOR. I just hope the economy grows more and more. Thank you, Mr. Chairman.

Senator ROTH. Congressman Richmond.

Representative RICHMOND. Thank you, Mr. Chairman.

Mr. Weidenbaum, I'm really distressed by your testimony and I'd like to go over it with you if I may, and I don't want to be arrogant or unpleasant, but I'm afraid you have totally missed the boat. You're a great economist academically. Have you had any experience in actually running factories?

Mr. WEIDENBAUM. Well, I must say I will quarrel with you on both scores. I really have no pretense of being a great economist.

Representative Richmond. I think you're a first class economist and—besides, you're from Brooklyn, so I'm doubly in favor of you.

Mr. WEIDENBAUM. I have worked in factories when I was working my way through college. I have dirtied my hands. I have seen close relatives go broke in small businesses.

Representative RICHMOND. I'm one that didn't go broke on small businesses. I have been running factories for 25 years, Mr. Weidenbaum, running them from start to finish.

Now you come up with this great statement and you clearly miss the most important point of all.

Mr. WEIDENBAUM. Which is?

Representative RICHMOND. The most important point of all is something we can learn from our German and Japanese partners. Why do they get more productivity than we do? Only one reason. They succeeded in making the unions their partners.

Now nowhere in your testimony do you mention the word "union." Productivity means nothing more than the type of arrangement you make with your unions. Now, Mr. Weidenbaum, what this nation needs——

Mr. WEIDENBAUM. I will agree with you.

Representative RICHMOND. What this Nation needs more than anything else is a new attitude toward labor. Labor must have a new attitude toward management. It's something I have been able to develop in my own company most successfully and as labor and management work together toward a common good, such as better quality, research and development, better productivity, better profits for everybody, better working conditions for everybody—that's how you get productivity. You will never get productivity in a million years unless you tie your labor unions in with your productivity plans.

Now nowhere in your testimony have you mentioned the word "unions."

Mr. WEIDENBAUM. I agree with you entirely.

Representative RICHMOND. Why don't you say something in your testimony about it?

Mr. WEIDENBAUM. For one basic reason. I don't think it's the Goverment's business to tell labor and management the relationship they should have.

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Representative RICHMOND. Unless the Government interferes, as they have in Germany and Japan and most other industrialized countries in the world, the unions and management will always be on two separate planets; and as long as they're on two separate planets, we will never get any productivity.

Mr. WEIDENBAUM. Well, you yourself, have given an example of your factories where apparently labor and management work together well.

Representative RICHMOND. We just recently acquired another forge plant. Those are forging people. It's a union. We have the boilermakers. We have to pay them $25 an hour for a forge worker, a hammerman—$25 an hour. That would work out to $50,000 a year. Now we could even compete with Japan on that basis, but we only get 30 minutes of the hour of productivity out of them. So, effectively, what we are doing is paying $100,000 per worker, per hammerman. As a result, Caterpillar Tractor Co., which is one of our great customers, just advised us that they were taking 80 percent of their business and shipping it to Japan. Why? Because the Japanese workers are paid just as well as our workers only they give you an hour of productivity for an hour of pay. Why? Because their unions are tied into their management. They work closely together and they understand their problems.

We just acquired this company and certainly we will sit down with the boilermakers and tell them that if they don't start cooperating with us we can't stay in business.

Mr. WEIDENBAUM. Certainly.

Representative RICHMOND. Why don't you say so in your testimony?

Mr. WEIDENBAUM. Because Government shouldn't get into the exclusive business of labor and management. They have to face the productivity problem themselves. I'm here as a Government official, therefore I'm testifying to the subcommittee as to what the Government should do or not do. If I were advising the unions or if I were advising the company, very frankly, I'd say just what you're doing. Don't rush to the Government for the solution of the productivity problem. Labor and management have to sit down and face it yourselves.

Representative RICHMOND. Don't you think plan No. 1 of our total Government policy should be understanding association talk—working with management and labor?

Mr. WEIDENBAUM. On the contrary, I think when Government gets in the way it's counterproductive.

Representative RICHMOND. Mr. Weidenbaum, right now the management and labor are not even talking to each other remotely.

Mr. WEIDENBAUM. There are many examples across this country where labor and management have talked on their own because of the pressures of competition.

Representative RICHMOND. Doug Fraser and Chrysler are the only examples I can think of.

Mr. WEIDENBAUM. There have been reports of some of the Japanese-owned plants in this country using American workers and using Japanese management where they outproduce the Japanese factories. So there's a lot to learn and I think you're on the right track.

Representative RICHMOND. You're quite right.

Mr. WEIDENBAUM. The solution is in the private sector, but not in terms of government getting its big nose involved in it. I think it's labor and management on their own who have the solution. The forces of competition, domestic and foreign competition, are going to encourage labor and management to do just what you have described—face the productivity problem themselves. And what Government should do, as I have indicated, is reduce the barriers that Government in the past unwittingly has imposed on productivity.

Representative RICHMOND. The Sony people tell me their best factory in the entire world is in San Diego. That's an interesting statement.

Mr. WEIDENBAUM. Precisely.

Representative RICHMOND. Which means we Americans can do it if we change our attitude, if management understands that it must get in bed with labor and labor understands it must get in bed with management. Otherwise, we're going to lose all our business.

Mr. WEIDENBAUM. And Government should keep out of that bed.

Representative RICHMOND. When you think that a company like Caterpillar is forced to buy heavy forgings from Japan—that isn't a complicated part. This is just a part that's been hammered. When you think they have to take 80 percent of their business away from us, whom they like very much and we have been working with them since both companies started, but they are forced to ship it to Japan due to the differential in labor cost—if you think of the horrendous amount of paying $100,000 for a blue collar worker for operating a hammer, you see the condition the American industry is in today. So I think you and the administration could do wonders if we could only get business and labor to understand that they must start sitting at the same table or else the rest of the economy is going to go down the tube.

Mr. WEIDENBAUM. To the extent that Government doesn't come around to help those companies and unions——

Representative RICHMOND. I just want Government to be a catalyst. Government should be a catalyst.

One other item you mentioned is that you're not unhappy with our investment on research and development. Well, I'm unhappy with our investment on research and development. It has slipped very badly these last 10 years. Both Germany and Japan spent more than double what we spent on research and development. I think America, there again, has fallen behind on R. & D. in the corporate management interest of showing profits, profits for their stockholders, which hasn't done a darn thing for the Dow Jones average anyway, so I can't imagine why they're so anxious to show profits.

Mr. WEIDENBAUM. I suggest you look at the profits. Companies invest more in research and development than the Federal Government does.

Representative RICHMOND. Right, but the companies in the United States spent less than half as much on research and development as they do in Germany and Japan.

Mr. WEIDENBAUM. Because of the reliance on the Government in this country. I think our tax credit to promote R. & D.——

Representative RICHMOND. R. & D. is tax deductible.

Mr. WEIDENBAUM. This increases the incentive to do R. & D. in the administration's proposal.

Representative RICHMOND. No, Mr. Weidenbaum. Research and development has always been deductible under every tax code.

Mr. WEIDENBAUM. It's how it's deductible.

Representative RICHMOND. It's tax deductible. It's an expense.

Senator ROTH. There's a proposal to make it a tax credit, so there is a greater incentive.

[The following table was subsequently supplied for the record at the request of Representative Rousselot:]

TABLE 5.—RESEARCH AND DEVELOPMENT EXPENDITURES IN LEADING INDUSTRIAL COUNTRIES AS A PERCENT OF GROSS NATIONAL PRODUCT, 1963–77

	1963	1967	1973	1977
United States	2.9	2.9	2.3	2.3
Canada	0.9	1.3	1.1	1.0
France	1.6	2.1	1.8	1.8
Germany	1.4	2.0	2.3	2.3
Japan	1.4	1.5	1.9	[1] 1.9
United Kingdom	[2] 2.3	2.3	[3] 2.1	([4])
U.S.S.R.	2.8	2.9	3.7	3.5

[1] 1976.
[2] 1964.
[3] 1975.
[4] Not available.

Source: National Science Foundation, "Science Indicators 1978," p. 140.

Representative RICHMOND. My time is up. Thank you very much, Mr. Chairman.

Senator ROTH. Let me make one observation because on the first point I think Congressman Richmond makes a very valid comment. I agree this country has to move from an adversarial relationship to one of cooperation or better understanding of mutual problems. I would only make one additional point. I think that the problem is not only the hostility that our laws have tended to build into the labor-management relationship, but we have the same kind of adversarial relationship among Government and business and labor. I think that's one reason we see something like 500,000 lawyers in this country compared with 15,000 lawyers; I'm a lawyer myself and my wife is. She's a practicing lawyer and she says I'm a bureaucrat. But the point I'm trying to make is that because of this adversarial relationship, labor hates business and business hates labor and everybody hates Government. That has to be reversed.

I am very concerned, to be candid, that we are using so much of our talent in the law, because that seems to be where so much of the opportunity is. So I think you make a valid point in focusing on the need to improve this working relationship.

I'd like to call on Congressman Rousselot. Welcome. Nice to have you.

Representative ROUSSELOT. Nice to be here, Mr. Chairman.

I appreciate your being here today, Mr. Weidenbaum, to contribute to Congress understanding of productivity.

As you know, Michael Evans was quoted yesterday in the Wall Street Journal in an article relating to our economy, and I will quote him directly. He said, "I think we are making real strides in productivity and we are setting the stage for wage increases to come down."

Do you agree with that statement? Was he being a little bit over optimistic?

Mr. WEIDENBAUM. Well, very frankly, over the years, I have been concerned about the relationship between productivity and wage increases. I'd like to see wages go up as fast as productivity could justify. I'd like to think positively about that. After all, I think this is why this hearing is so important. The constructive response isn't to dampen down wage increases but to justify wage increases that are not inflationary by increasing productivity.

I think that, to me, is the most constructive way.

Representative ROUSSELOT. Do you think that some of the labor contracts should tie wage increases to productivity increases, as has been suggested in the past?

Mr. WEIDENBAUM. Well, only as a private thing.

Representative ROUSSELOT. I'm not sure we should change it.

Mr. WEIDENBAUM. That's precisely it. Sitting where I sit now, as you may have heard in my colloquy with Congressman Richmond, I think Government should be less involved in labor-management relations. But as an individual economist, I do think that labor and management both need to be more mindful of the relationship between productivity growth and salary and wage increases, and those industries that haven't paid sufficient attention to this are precisely some of the ones that the chairman cited earlier that have run into severe trouble.

Representative ROUSSELOT. Well, do you feel that indexing wage increases to productivity increases would be a helpful tool in a labor contract. Obviously, we can't dictate from here.

Mr. WEIDENBAUM. Well, as I say, wearing my Government hat, I wouldn't presume to suggest to labor or mangement how to conduct collective bargaining negotiations. As an economist, I would like to see, very frankly, more attention to productivity in the collective bargaining process. But how that's done is a private matter. I don't think Government should be involved.

Representative ROUSSELOT. I understand it's a private matter, but do you think that a productivity-wage tie would be a helpful thing to have in a labor contract?

Mr. WEIDENBAUM. Providing it's not automatic, because as you know, it's in a lot of—the reason for my hesitation is, it's in a lot of contracts—a so-called productivity factor is in a lot of contracts now and it's triggered automatically whether there's any increase in productivity in that company or that industry or not. That's my concern.

Representative ROUSSELOT. You're saying it should be tied very strictly to whether there are genuine productivity increases?

Mr. WEIDENBAUM. Unfortunately, then, you have very practical questions as to how well can you measure your productivity in a given factory, in a given plant, or even in a given industry.

Representative ROUSSELOT. How good are our productivity measurements?

Mr. WEIDENBAUM. Frankly, not very good. There is great debate in the economics profession as to the causes for the slowdown and stagnation in productivity over the recent years. Ed Dennison, one of the outstanding students of this subject, has labeled part of that "a mystery." So, unfortunately, productivity is one of the areas where our statistics are rough. We have to acknowledge that. But rough as they are, I think it's quite clear that we are suffering from a pervasive slowdown in productivity. I think that is clear. To the nearest decimal point, I don't have that degree of confidence in the numbers.

Representative ROUSSELOT. Well, let me come back to Mr. Evans' statement. How accurate do you think he is when he says "I think we are making real strides in productivity"?

Mr. WEIDENBAUM. Well, certainly the first quarter numbers—he's accurate for the first quarter. I think in order to get sustained increases in productivity in the years ahead we're going to need changes in Government policy. I don't think the status quo is adequate.

Representative ROUSSELOT. Well, you have indicated in your statement several things that you think would help bolster productivity.

Mr. WEIDENBAUM. Yes, sir.

Representative ROUSSELOT. And so I assume we could follow those suggestions.

Mr. WEIDENBAUM. The last part of my prepared statement really tries to wrap it up.

Representative ROUSSELOT. Now, let's shift to money growth. The President has mentioned that money growth is definitely a factor in inflation. How can the Federal Reserve be influenced in restraining money growth?

Mr. WEIDENBAUM. Well, as I observe the situation, what has happened is a bit different and that is very heartening. That is, as the Federal Reserve has followed a program of monetary restraint, we are seeing the inflation rate come down significantly and we are beginning to see a measurable decline in interest rates and I think that, very frankly, is cause and effect. It works. I think it's the monetary restraint which, when pursued—not a stop and go policy as was done too frequently in the past, but a sustained slowdown in the growth rate of money and credit—will get precisely what we are beginning to see—lower rates of inflation and lower rates of interest.

Representative ROUSSELOT. Well, we've seen some slowdown in the money growth situation, but how long is the lag time between money growth and lower inflation?

Mr. WEIDENBAUM. In my observation over the years, there isn't a constant lag. That lag relationship shifts. I think the lags are very short now because we are seeing in the last few months such a lower rate of inflation, so that quite clearly this program of monetary restraint is taking hold and showing its beneficial effects right now.

Representative ROUSSELOT. Thank you, Mr. Chairman. My time has expired.

Senator ROTH. Thank you, Mr. Weidenbaum. We know you have many demands on your time, so——

Representative RICHMOND. I have just one question.

Senator ROTH. We have one more question.

Representative RICHMOND. Thank you, Mr. Chairman.

Mr. Weidenbaum, you remember the Packard slogan that made the Packard man famous: "Ask the man who owns one"?

Mr. WEIDENBAUM. I can even remember the Ford one.

Representative RICHMOND. You mentioned in your summary three items, reduce the heavy burden of taxes, reduce the heavy burden of regulations, and reduce the heavy burden of inflation.

Mr. WEIDENBAUM. Yes.

Representative RICHMOND. I can give you three other items that will actually do something to productivity in a factory because, Mr. Weidenbaum, we can't think of great wonderful thoughts up here. We must get down into that factory. What are the three things that mean something to me? No. 1, we have already discussed labor-management relations which are far and above the most important of all. No. 2, plant engineering. That's something that unless you have been in the business you don't realize. Just about a month ago I visited a Toyota assembly plant in Toyota City. I went to a plant 7 acres in size. Do you know how many employees they have? One hundred and seventy. Now does that mean that that plant had great productivity or does that mean that that plant was beautifully laid out by first class plant engineers who really knew how to lay out a factory? It wasn't productivity, Mr. Weidenbaum. If they had 170 or 217 people, Toyota still would have had a very profitable operation going. The fact is you walk blocks and blocks around and you didn't see a living soul. The whole plant was totally automated. It was an engine block factory. Occasionally you would see a white jacket of a supervisor.

What I'm trying to bring out is this Nation needs better labor-management relations and then we've got to develop much, much better plant engineering. One of the biggest problems of productivity is the plants aren't laid out properly.

Then, third, we have to redesign our products to make them easier and more efficient to produce.

So if you would forget all these esoteric things and get down to the problems of today's manufacturers, I think all of us could increase productivity materially.

Mr. WEIDENBAUM. Congressman, when I used to walk——

Representative RICHMOND. Taxes don't bother me particularly.

Mr. WEIDENBAUM. When I used to walk the factory floors when I worked in the aerospace industry for many years, I was well aware of the problems of plant design, of product design, of labor-management relations, but I am also aware of who's responsible. And my strong urging here is to realize that you're putting your finger on very fundamental private sector, business-labor questions, not Government questions. I strongly share your view as to who really can do the most good on productivity. It's no one in this city. It's individual workers and individual managers.

Representative RICHMOND. With Government acting as a catalyst.

Mr. WEIDENBAUM. On the contrary. Every time Government, however, well-intentioned, has tried to get involved, it has been counterproductive, and that's why perhaps my statement sounds a bit esoteric to you. Why? Because it will pull Government away from the factory floor rather than push it onto the factory floor, and all those who own factory floors, like you, I think can appreciate that.

Senator ROTH. Mr. Rousselot.

Representative ROUSSELOT. Thank you, Mr. Chairman.

Isn't it true that one of the reasons Japan is so successful, as has already been mentioned, that many Japanese plants are highly automated? Are the Japanese encouraged to invest in automated facilities? Is it true that the Japanese tax incentives are greater than ours?

Mr. WEIDENBAUM. You're absolutely right. Their tax incentives are greater and their investment incentives are much greater; yes, sir.

Representative ROUSSELOT. Thank you, Mr. Chairman.

Senator ROTH. Thank you, Mr. Weidenbaum.

Mr. WEIDENBAUM. Mr. Chairman, thank you, and thank the subcommittee for your courtesy.

Senator ROTH. At this time we are very pleased to have the Under Secretary of Treasury, a well-known economist, Mr. Ture. We would ask, if it is possible, for you to summarize your prepared statement. We will include it in the printed record. Will you please proceed?

STATEMENT OF HON. NORMAN B. TURE, UNDER SECRETARY OF THE TREASURY FOR TAX AND ECONOMIC AFFAIRS

Mr. TURE. Thank you, Mr. Chairman. It's a pleasure to be here with you today and I certainly commend the subcommittee for directing its attention to a very important subject. That subject is one that has commanded all of our attention. That is the Nation's lagging productivity growth and we're all concerned about what public policy can do to improve that record.

I think that this concern for productivity growth is a central matter in the administration's economic program. In my testimony today I'd like to review the recent history of U.S. productivity growth in the context of the record for the last three decades, examine some of the reasons for the observed decline, and explain how the President's economic program will reverse the recent trend in productivity growth.

Although there are alternative and more complex measures of productivity which compare output relative to all factor inputs, I shall employ in my presentation today the most commonly used measure; namely, output or productivity per man-hour.

In table I of my prepared statement you will see the rate of output per man-hour in private business had declined markedly and at an accelerating pace since the 20-year period 1948–68. The average rate of productivity advance was 3.1 percent per annum in the 1948–68 period. It fell to 2.2 percent in the next 5 years and dropped to 0.6 percent in the recent 1973–80 period.

A more detailed examination of the anatomy of the decline in productivity growth is presented in table II which contains the respective records of productivity growth of the major sectors. The data suggest that although the decline was quite broad, it was not universal among all industrial sectors. With the exception of the communication and financial sectors, however, the decline in productivity growth accelerated dramatically in the 1973–79 period.

Within manufacturing one can observe significant variations in the growth of productivity. Motor vehicles, for instance, experienced an increase of approximately 4 percent per year in the 1973–78 period while steel experienced a decline of 1 percent.

Let me turn now to the causes of the productivity slowdown. Before we leap to unfortunate conclusions about it, I think it behooves us to try to explain what's been going on. An answer to this question requires an understanding of the determinants of productivity. In the large, the single most important determinant of productivity per man-hour is the quantity of capital—plant and equipment—per worker. Accordingly, other things being equal, when the amount of capital grows more rapidly than the amount of labor, productivity per worker increases. Conversely, when the amount of capital grows more slowly than the growth in labor input into production, the productivity of labor decreases.

The dynamics of this relationship are particularly important. While temporary or short-lived interruptions of productivity advance may be accepted, sustained decelerations are a source of increasing social tension and dissatisfaction. The reason is clear. The rate of advance of productivity determines the rate of advance of real wage rates. Since wages and salaries comprise roughly four-fifths of the national income and are the principal income source for most families, deceleration in the advance of real wage rates, let alone a decline, means retardation in the advance of living standards for most of us. We are concerned, therefore, not only with increasing productivity, but with, at the least, sustaining the rate of that increase.

Maintaining the rate of productivity advance calls for not merely increasing the amount of capital per man-hour, but for increasing that ratio at a steady rate. If the gain in the capital to labor ratio slows, the gain in productivity will also slow.

The evidence here is most revealing. The ratio of the net stock of capital, excluding capital applied to pollution abatement, to man-hours grew at an average annual rate of 3.6 percent in the 1948–68 period and 2.7 percent per year in the 1968–73 period. The ratio declined dramatically to 1.1 percent per year, however, in the 1973–79 period. Thus, an important cause of the slowdown in the rate of increase in productivity per man-hour is the dramatic decline in the rate of growth of capital per worker.

This resulted in two factors: A significant decrease in the growth rate of the net capital stock over the period; and a dramatic increase in the man-hours worked during the 1973–79 period.

The decline in the rate of growth of capital occurred even though the share of nonresidential fixed investment, including outlays for pollution abatement, in real GNP did not change dramatically during the post-World War II period. During the 1949–68 period it averaged 9.4 percent, rose to about 10.5 percent during 1969–73, and was about the same, 10.4 percent per year, during the 1974–80 period.

While the total share of nonresidential investment remained relatively unchanged, the mix between structures and shorter lived equipment changed. The share of structures declined from 3.9 percent of real GNP during the 1948–68 period to 3.2 percent during the years 1973–79.

One indication of this shift toward shorter lived assets is the fact that the ratio of net investment to gross investment has declined. Thus, even though total nonresidential investment remained relatively unchanged as a share of GNP, net investment, which represents additions to the stock of capital, declined as a fraction of GNP. The extent to which this decline in the durability of capital is attributable to the interaction of taxes and inflation is an issue to which I will return later in my testimony.

While the capital-labor ratio is a very important determinant of productivity per worker, it is not the only one. It is, however, the one that is most readily measured and quantified. Other factors affecting productivity must be cited although their measurement and, thus, contribution to productivity are far more difficult to define or quantify. While students of the subject may arrive at similar lists of the causes of the decline in productivity growth, there does not appear to be firm agreement as to the importance of each of the causes. Thus, the best one can do, given the current state of knowledge on the subject, is to identify these factors and later on suggest how the administration's economic program will affect them.

The age-sex mix of the labor force began to change significantly in the midsixties when a large number of relatively unskilled or inexperienced young people and women entered the labor force. The young people and the ladies entering the labor force did not primarily go into manufacturing which is our high productivity industry. They went into trades, services, finance, or similar employment which, while they have relatively rapid rates of growth in productivity, have relatively low levels of productivity.

Shifts in capital and labor which have occurred from agriculture to other sectors were an important contributor to the development in productivity trends in the recent period.

Another major input to explanation of the changes in productivity which I'm sure Mr. Weidenbaum has alluded to already, is the impact of Government-mandated regulations. These increased dramatically during the 1970's, as we all know. And, as we all know, whatever useful purposes these regulations serve, as I think they do, they also impose a variety of costs which very often have the effect of deterring productivity growth.

To illustrate, one sector that is often cited as one in which productivity fell in response to mandated regulations is mining. As noted in the tables in my prepared statement, productivity in the mining sector declined sharply during the period 1973–79.

Another factor associated with regulatory policy, though not exclusively so, was the dramatic increase in energy prices since 1973. This had a significant effect with respect to the utilization of capital and capital services, although a large part of our capital stock became energy inefficient and therefore the net impact was to slow productivity growth.

Advances in technical knowledge are very widely agreed to be an important determinant of productivity change. I know of no solid economic research which does not affirm that conclusion, but I similarly know of very little solid economic research which explains the source of productivity advance, the impulses of productivity advance, and therefore explains in a satisfactory way why under some circumstances productivity technology advances very rapidly and in other circumstances very slowly.

Shortrun cyclical variations have an impact on productivity growth. The rate of productivity growth tends to decline during recessions and to accelerate during recoveries as business adjusts the use of labor and capital relative to output and sales because percentage changes in output tend to exceed percentage changes in the use of labor services. It is problematical whether these short-term perturbations are significant with respect to the long-term trend in productivity which should be a principal concern.

Whatever the relative contribution of all these various factors to the retardation of productivity growth in the last half decade or more, the sharp decrease in the capital labor ratio which is to be observed has to be deemed to be one of the principal causes. The question, then, is why the gain in the net stock of capital declined so dramatically in relation to the growth in labor? And the answer lies, in large part, as I have indicated earlier, in the interaction of the tax system and the inflation process.

As we all know, inflation accelerated significantly from the mid-1970's to the present time and it is that interaction with our tax system which I think affords a substantial part of explanation for our recent difficulty. We have had a decade of sustained and accelerated inflation which has interacted with the tax system in a way which decreases sharply incentives for capital formation. The degree of the tax penalty has not been uniform in one industry or among different uses of capital. The disincentives for capital formation and the capital movements induced by inflation have had significant adverse effects on the overall productivity.

Since businesses may deduct, under our existing tax laws, only the historical cost of plant and equipment they use and they deduct these costs over a number of years, what inflation does is to reduce the real value of depreciation deductions and therefore to overstate profits subject to tax. The effect of this, obviously, is to raise real tax rates on the returns to capital and lower the net returns available for rewarding people for foregoing current consumption.

The higher real tax rates on depreciable capital brought about by inflation cause capital to flow away from those industries that have historically high rates of growth or high levels of productivity. The industries that have suffered the most from this problem are manufacturing, transportation, and utilities, which all have high ratios of depreciable capital per employee, and I note that in table IV.

On average, the overall impact of higher real tax rates on returns to depreciable capital has been to provide incentives for reallocation of resources away from the higher productivity areas. Higher real tax rates to depreciable capital also affect the allocation of capital between taxable and nontaxable uses, such as owner-occupied housing; and furthermore, inflation also disproportionately raises the cost of using longer lived capital and thus tilts business decisions toward the use of short-lived capital.

Inflation has also pushed Americans into higher tax brackets, and the average citizen now faces sharply higher marginal tax rates than a decade ago. Higher marginal tax rates decrease the incentives to save and, hence, reduce the resources committed to capital formation.

The administration is proposing a bold and dramatic economic program to reverse these adverse trends in productivity. Let me not dwell on those since you're all familiar with them.

What I want to address myself to is the tax program. A key element in that tax program is the accelerated cost recovery system proposal, ACRS. ACRS will reduce the damage inflation has done to depreciation allowances. It will stimulate capital formation and promote a more efficient use of capital by decreasing the real tax rate on returns to capital and promote incentives for saving and investing. Regardless of the cause of the productivity decline, it is widely agreed that increased capital formation is a necessary element in reversing the recent trends.

ACRS will eliminate the bias inflation has created against depreciable assets. It will shift capital toward those industries which are intensive users of depreciable capital including manufacturing, transportation, and communication. It will spur investment in all sectors, especially those hardest hit by inflation. This will help reverse recent productivity trends.

ACRS will also provide a capital recovery system that is much more nearly neutral among types of capital than the existing depreciation system. As a consequence, ACRS will help to arrest the trend toward the use of less durable equipment. Longer lived equipment will now become relatively more profitable, and firms will respond by lengthening the effective life of their plant and equipment. This will lead to a more durable and more efficient capital stock.

An integral part of our program to promote capital formation and increase productivity is the scheduled reduction in personal income tax rate which will result in lower marginal tax rates. Those potential productivity gains are very substantial indeed.

It has become increasingly evident, however, that other dimensions of work effort can be affected by marginal tax rates, particularly in the case of second earner families. In particular, work intensity and occupational choice can also be influenced by marginal tax rates. To the extent that high marginal rates have led to a diminution of work effort, the proposed personal rate cuts can help to reverse recent adverse productivity trends.

The administration is proposing several other changes in personal and business income taxation that will directly improve, we believe, productivity.

Marriage tax penalty relief, which we have proposed, in the form of a 5-percent exclusion up to $1,500 in 1982 and a 10-percent exclusion up to $3,000 in 1983 and thereafter. I think that's a particularly significant proposal in this respect.

A reduction in the top marginal tax rate on investment income from 70 percent to 50 percent is also significant.

An increase in deductibility of IRA and Keogh account limits and eligibility should make a significant contribution, particularly for retirement income, and therefore relieve the social security system through the years of the burden which it is increasingly finding difficult to bear.

The dividend and interest exclusion provisions which are due to expire at the end of 1982 are to be made permanent and we believe they will constitute and renew and reinvigorate the incentive for saving.

There is a proposed estate and gift tax relief.

And to encourage research and development we have proposed not only a more liberal tax treatment of capital outlays for R. & D. purposes but a new tax credit for wages and salaries for expenses incurred in R. & D. activity as well.

All of these changes will increase output and improve productivity. Reducing the marriage penalty will provide an additional work incentive for second earners. Reducing the top marginal tax rate on investment income, expanding the scope of IRA and Keogh plans, and making permanent the interest and dividend exclusion will all stimulate saving by directly increasing the rate of return available to investors. The research and development tax credit will provide firms with an added incentive to engage in basic research.

In conclusion, we find that recent productivity development have contributed to many of the economic problems of the 1970's, and these problems are still with us today.

We believe the President's economic recovery program will have a salient impact on advancing productivity during the 1980's. The combination of tax, spending, monetary, and regulatory changes will provide incentives for increasing saving and investment and provide incentives for more efficient and productive allocations of our capital and labor resources and will reduce many of the barriers that have contributed to lagging productivity growth. Thank you.

[The prepared statement of Mr. Ture follows:]

Prepared Statement of Hon. Norman B. Ture

Mr. Chairman and members of the subcommittee, it is a pleasure to be with you today. The subcommittee is to be commended for directing its attention to a very important subject, the Nation's lagging productivity growth and the contribution that public policy can make to restore momentum to productivity advance.

The concern for productivity growth is central to the Adminstration's economic program. Resumption of steady increases in our standard of living and in a our ability to meet our security needs will be greatly affected by development in regard to productivity.

In my testimony today I should like to review the recent history of U.S. productivity growth in the context of the record for the last three decades, examine some of the reasons for the observed decline, and explain how the President's economic program will reverse the recent trend in productivity growth.

Although there are alternative and more complex measures of productivity which compare output relative to all factor inputs, I shall employ in my presentation today the most commonly used measure, namely, output or productivity per manhour.

Aggregate Productivity Changes

As Table I indicates, the rate of increase in output per manhour in private business has declined markedly and at an accelerating pace since the 20-year period 1948–68. The average rate of productivity advance was 3.1 percent per annum in the 1948–68 period; it fell to 2.2 percent in the next five years and dropped to 0.6 percent in the recent 1973–80 period. If the agricultural sector is excluded from these numbers, the productivity picture is even less favorable: in the 1948–68 period private nonfarm productivity rose at an annual average of 2.6 percent; the growth rate slowed to 1.9 percent per year during the 1968–73 period and slowed further to 0.5 percent a year during the seven years ending in 1980.

COMPARATIVE TRENDS AMONG SECTORS

While the broader trends of productivity changes are generally familiar to most analysts, the comparative trends among sectors are not as well known. A more detailed examination of the anatomy of the decline in productivity growth is presented in Table II which contains the respective records of productivity growth of the major sectors. The data suggest that although the decline was quite broad it was not universal among all industrial sectors. With the exception of the communication and financial sectors, however, the decline in productivity growth accelerated dramatically in the 1973-79 period (productivity data by sector are not yet available for 1980).

Within manufacturing one can observe significant variations in the growth of productivity; motor vehicles, for instance, experienced an increase of approximately 4 percent per year in the 1973-78 period while steel experienced a decline of 1 percent. In addition, in two sectors, construction and mining, productivity per manhour not only did not increase, but it actually declined (Table II). In mining, the decline in output per manhour was an average of 5.2 percent per year for the 1973-79 period; in construction the decline in labor productivity started in the 1968-73 period (−1.8 percent per year) and accelerated during the 1973-79 period (−2.8 percent per year). In several other sectors, e.g., wholesale and retail trade, services, and finance, insurance, and real estate, the rise in output per manhour during the years 1973-79 averaged less than 1 percent per year. In both services and manufacturing, some acceleration of productivity advance occurred in the years 1968-1973, compared with the prior decades.

There does not seem to be a close relationship between productivity changes and levels of productivity. In some sectors these that have had the slowest productivity growth also had the lowest level of output per manhour (e.g., construction, retail trade services). In others, e.g., mining, wholesale trade and finance insurance and real estate, the level of productivity has been high, but the growth during one or more of the periods has been slower than average. In agriculture, productivity growth has been faster than average, but the level or productivity has been well below the average level for the private business sector.

CAUSES OF PRODUCTIVITY SLOWDOWN

What are some of the causes for this disappointing productivity record? An answer to this question requires an understanding of the determinants of productivity. The single most important determinant of productity per manhour is the quantity of capital—plant and equipment—per worker. Accordingly, other things being equal, when the amount of capital grows more rapidly than the amount of labor, productivity per worker increases. Conversely, when the amount of capital grows more slowly than the growth in labor input into production, the productivity of labor decreases.

The dynamics of this relationship are particularly important. While temporary or short-lived interruptions of productivity advance may be accepted, sustained decelerations are a source of increasing social tension and dissatisfaction. The reason is clear. The rate of advance of productivity determines the rate of advance of real wage rates. Since wages and salaries comprise roughly four-fifths of the national income and are the principal income source for most families, deceleration in the advance of real wage rates, let alone a decline, means retardation in the advance of living standards for most of us. We are concerned, therefore, not only with increasing productivity but with, at the least, sustaining the rate of that increase.

Maintaining the rate of productivity advance calls for not merely increasing the amount of capital per manhour, but for increasing that ratio at a steady rate. If the gain in the capital to labor ratio slows, the gain in productivity will also slow.

The evidence here is most revealing. The ratio of the net stock of capital, excluding capital applied to pollution abatement, to manhours grew at an average annual rate of 3.6 percent in the 1948-68 period and 2.7 percent per year in the 1968-73 period. The ratio declined dramatically to 1.1. percent per year, however, in the 1973-79 period. Thus, an important cause of the slowdown in the rate of increase in productivity per manhour is the dramatic decline in the rate of growth of capital per worker.

This decline in the capital labor ratio resulted from a significant decrease in the growth rate of the net capital stock over the period (from 4.2 in 1948-1968 to 3.0 percent in the 1973-79 period) and a dramatic increase in manhours worked during the 1973-79 period.

The decline in the rate of growth of capital occurred even though the share of nonresidential fixed investment, including outlays for pollution abatement, in real GNP did not change dramatically during the post-World War II period. During the

1949–68 period it averaged 9.4 percent, rose to about 10.5 percent during 1969–73, and was about the same, 10.4 percent per year, during the 1974–80 period.

While the total share of nonresidential investment remained relatively unchanged, the mix between structures and shorter-lived equipment changed. The share of structures declined from 3.9 percent of real GNP during the 1948–68 period to 3.2 percent during the years 1973–79.

One indication of this shift towards shorter-lived assets is the fact that the ratio of net investment to gross investment has declined. Thus, even though total nonresidential investment remained relatively unchanged as a share of GNP, net investment, which represents additions to the stock of capital, declined as a fraction of GNP. The extent to which this decline in the durability of capital is attributable to the interaction of taxes and inflation is an issue to which I will return later in my testimony.

While the capital labor ratio is a very important determinant of productivity per worker, it is not the only one. It is, however, the one that is most readily measured and quantified. Other factors affecting productivity must be cited although their measurement and, thus, contribution to productivity are far more difficult to define or quantify. While students of the subject may arrive at similar lists of the causes of the decline in productivity growth, there does not appear to be firm agreement as to the importance of each of the causes. Thus, the best one can do, given the current state of knowledge on the subject, is to identify these factors and later on suggest how the Administration's economic program will affect them.

The age-sex mix of the labor force began to change significantly in the mid-sixties when a large number of relatively unskilled or inexperienced young people and women entered the labor force. Youths between the age of 16 and 24 comprised 21.5 percent of the labor force in 1970 and 23.5 percent in 1980. Similarly, the proportion of women in the labor force increased from 38.1 percent to 42.6 percent between 1970 and 1980. Since the official productivity data are not adjusted for changes in the composition of the labor force, the significant influx of inexperienced workers into the labor force and especially into low productivity industries contributed to the measured productivity decline.

Shifts in capital and labor from agriculture to other sectors were an important contributor to productivity growth for the first two decades after World War II, since the marginal productivities of capital and labor in nonfarm employment were higher than in farm employment. These shifts essentially ended at the beginning of the 1970s resulting in the removal of an important source of productivity growth.

Government-mandated regulations increased dramatically during the 1970's. These regulations impose a variety of costs which deter productivity growth. First, they require the allocation of current resources to meeting these regulations; second, they reduce the rate of return to capital investment and, thus, deter capital formation; and third, the uncertainty surrounding the regulations and their implementation greatly hinders and slows down the rate of investment.

A sector that is often cited as one in which productivity fell in response to mandated regulations is mining. As noted earlier, productivity in the mining sector declined sharply during the period, 1973–79. If the outputs sought by these regulations could be objectively valued and if such values were significant, to the extent these regulations, whether they were cost effective or not, resulted in increased production of such outputs—clean air, for instance—the standard measurement of productivity growth would understate the actual advance.

The dramatic increase in energy prices since 1973 has undoubtedly had a significant effect on productivity growth. The increase in energy prices made certain portions of the capital stock obsolete because of its specialization in the use of relatively high-cost energy supplies and, thus, affected adversely the capital labor ratio. Furthermore, to the extent that capital input and energy input complement one another, the increase in energy prices tends to deter capital formation and results in a substitution of labor for capital which reduces measured labor productivity growth.

While there is general agreement among students of the subject that rising energy prices contributed to the decline in productivity growth, there is little agreement regarding the magnitude of the effect. It is interesting to note, however, that all major industrialized countries experienced a signficant decline in productivity growth after 1973, which suggests that the impact of higher energy costs was significant even though we are unable to measure this effect directly.

Advances in technological knowledge are also important determinants of productivity change. Despite their recognized importance, well agreed-upon measures of the stock of knowledge are not available. Investigators of the subject have attempted to measure it through expenditures on research and development, employment in these activities, and the issuance of patents. All of these measures have serious deficiencies as indicators of technological knowledge. Nevertheless, there appears to be a consensus that part of the slowdown in the growth in productivity is attributable to a decline in the rate of increase of our stock of knowledge.[1]

Short-run cyclical variations have an impact on productivity growth. The rate of productivity growth tends to decline during recessions and to accelerate during recoveries as business adjusts the use of labor and capital relative to output and sales because percentage changes in output tend to exceed percentage changes in the use of labor services. It is problematical whether these short-term perturbations are significant with respect to the longer-term trend in productivity which should be a principal concern.

Whatever the relative contribution of the other factors to the retardation of productivity advance, the sharp decrease in the capital labor ratio must be deemed to be a principal cause. The question, then, is why the gain in the net stock of capital declined so dramatically in relation to the growth in labor. The answer lies, in large part, in the tax system and its interrelation with inflation.

INFLATION AND THE TAX SYSTEM

Unfortunately, a decade of sustained inflation has interacted with the tax system to decrease sharply incentives for capital formation. The degree of the tax penalty has not been uniform among industries or among different users of capital. The disincentives for capital formation and the capital movements induced by inflation have had adverse effects on productivity.

Since businesses may deduct only the historical cost of plant and equipment over a number of years, inflation reduces the real value of depreciation deductions and overstates true profits. This raises real tax rates on the returns to capital and lowers the net returns available for rewarding people for forgoing current consumption. Inflation also creates uncertainty about the true value of depreciation and adds further risk to investment projects.

The erosion of depreciation deductions affects only depreciable capital. It does not have a direct effect on assets for which depreciation is not a factor, such as inventories, land, intangible assets, financial claims, and owner-occupied housing. As inflation increases the tax burden on depreciable assets, it causes savings to flow to those uses and industries where depreciable capital is a less significant component of total resources employed.

The higher real tax rates on depreciable capital brought about by inflation cause capital to flow away from those industries that have historically high rates of growth or high levels of productivity. The industries that have a suffered the most from this problem are manufacturing, transportation, and utilities which all have high ratios of depreciable capital per employee. (See Table IV.) Except for the most recent period in which utilities have been burdened with rapidly rising energy prices, these industries have exhibited sustained productivity growth. Services, trade, and construction have been relatively less affected by this problem, and these are the industries that historically have had relatively poor productivity performances. On average, the overall impact of higher real tax rates on returns to depreciable capital has been to provide incentives for a reallocation of resources away from the higher productivity areas. Many observers attribute some of the recent productivity decline to this shift in resources.

Higher real tax rates on returns to depreciable capital also affect the allocation of capital between taxable and nontaxable uses. A primary example of this is the incentives for investments in owner-occupied housing. While housing capital is certainly an important use of the Nation's resources, diverting capital away from manufacturing and industrial uses may also have contributed to our recent productivity decline.

Inflation also disproportionately raises the costs of using long-lived capital and, thus, tilts business decisions towards the use of short-lived assets. This distortion of the composition of capital has precisely the same effect as a decrease in the overall level of the capital stock, namely, a reduction in productivity.

Inflation has also pushed Americans into higher tax brackets, and the average citizen now faces sharply higher marginal tax rates than a decade ago. Higher marginal tax rates decrease the incentives to save and, hence, reduce the resources committed to capital formation. Higher marginal tax rates also have subtle effects on work effort and risk-taking that eventually take their toll on productivity performance.

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[1] In significant part, the implementation of technical advances requires capital formation. Decline of capital formation, therefore, may be associated with a slowdown in the advance of technology. To be sure, it may be that both of these retardations are responses to a common factor, rather than one accounting for the other.

THE PRESIDENT'S ECONOMIC PROGRAM

The Administration is proposing a bold and dramatic economic program to reverse these adverse trends in productivity. The program will restore an environment in which the after-tax, after-inflation return for working, saving, and investing is substantially higher than exists today. The Administration's economic program has four components:

A stringent budget policy: Excessive growth of government spending and large budget deficits divert resources from the private sector that might otherwise have been invested in productive plant and equipment. The budget restraint recommended by the President and supported by the Congress in its First Budget Resolution is, therefore, an important part of our effort to free up private savings for investments that will contribute to a more productive and stronger economy.

A regulatory reform program: Similarly, the rapid growth of Federal regulations that are not cost effective has retarded private investment and economic growth. The President's proposals for regulatory reform will help reverse this adverse situation by reducing the inefficiencies and costs that are deterring production and raising prices.

A noninflationary monetary policy: Slow, steady growth in the stock of money is essential for controlling inflation. Reduced inflation will encourage long-term planning and investment and, thus, promote faster growth of productivity.

An incentive tax policy to increase the after-tax returns for work, saving, and investments.

All of these policies are mutually reinforcing. Together they will provide the type of economic environment that America needs to create the jobs, investment, and improvements in the standard of living necessary to meet its goals.

ACCELERATED COST RECOVERY SYSTEM

A key element of the President's tax package in so far as investment and productivity growth are concerned is the Accelerated Cost Recovery System (ACRS) proposal. ACRS will reduce the damage inflation has done to depreciation allowances. It will stimulate capital formation and promote a more efficient use of capital by decreasing the real tax rate on returns to capital and promote incentives for saving and investing. Regardless of the cause of the productivity decline, it is widely agreed that increased capital formation is a necessary element in reversing the recent trends.

ACRS will eliminate the bias inflation has created against depreciable assets. It will shift capital toward those industries which are intensive users of depreciable capital including manufacturing, transportation, and communication. It will spur investment in all sectors, especially those hardest hit by inflation. This will help reverse recent productivity trends.

ACRS will also provide a capital recovery system that is much more nearly neutral among types of capital than the existing depreciation system. As a consequence, ACRS will help to arrest the trend towards the use of less durable equipment. Longer-lived equipment will now become relatively more profitable, and firms will respond by lengthening the effective life of their plant and equipment. This will lead to a more durable and more efficient capital stock.

REDUCTIONS IN MARGINAL TAX RATES

An integral part of our program to promote capital formation and increase productivity is the scheduled reduction in personal income tax rates. Lower marginal tax rates will aid capital formation in several ways. By increasing the after-tax return to saving, individuals will have increased incentives to increase their savings, hence to provide the resources necessary for increased capital formation.

Reducing marginal tax rates will also lead to a more productive allocation of savings among capital uses. As marginal tax rates fall, tax shelters become less attractive. Investors no longer need to seek out investments whose primary return comes in the form of tax savings. Instead, investments can be guided more by pretax profitability which measures the contribution of capital to total output. The potential productivity gains resulting from a switch away from tax shelters are substantial.

It is now commonplace that reducing marginal tax rates can have important effects on labor supply, particularly for second-earners in families and others who currently face steep marginal tax rates. But it has become increasingly evident that other dimensions of work effort can be affected by marginal tax rates. In particular, work intensity and occupational choice can also be influenced by marginal tax rates. To the extent that high marginal rates have led to a diminution of work effort, the proposed personal rate cuts can help to reverse recent adverse productivity trends.

OTHER PRODUCTIVITY INCENTIVES

The Administration is proposing several other changes in personal and business income taxation that will directly improve productivity.

Marriage tax penalty relief in the form of a 5 percent exclusion up to $1,500 in 1982 and a 10 percent exclusion up to $3,000 in 1983 and thereafter.

A reduction in the top marginal tax rate on investment income from 70 percent to 50 percent.

An increase in IRA and Keogh account limits and eligibility.

The dividend and interest exclusion provision due to expire at the end of 1982 will be made permanent.

Estate and gift tax relief.

To encourage research and development, a new tax credit for R&D will be introduced.

All these changes will increase output and productivity performance. Reducing the marriage penalty will provide an additional work incentive for second-earners. Reducing the top marginal tax rate on investment income, expanding the scope of IRA and Keogh plans, and making permanent the interest and dividend exclusion will all stimulate saving by directly increasing the rate of return available to investors. The research and development tax credit will provide firms with an added incentive to engage in basic research.

CONCLUSION

Recent productivity developments have contributed to many of the economic problems of the 1970s, and these problems are still with us today. In order to reduce inflation, raise the standard of living, and strengthen our international competitiveness, public policies must be more attuned toward, improving the productivity performance of our factors of production.

The President's Economic Recovery Program will have a salient impact on productivity trends of the 1980s. The combination of tax, spending, monetary, and regulatory changes will provide incentives for increased saving and investment and weaken many of the barriers that have contributed to lagging productivity growth.

TABLE I.—CHANGE IN AGGREGATE OUTPUT PER HOUR

[Percent change, annual rate]

	1948–68	1968–73	1973–80
Private business	3.1	2.2	0.6
Private nonfarm business	2.6	1.9	0.5
Manufacturing	2.8	3.6	1.2

Note.—Labor data are based on hours paid.

Source: U.S. Department of Labor, Bureau of Labor Statistices.

TABLE II.—GROWTH IN PRODUCITIVITY BY INDUSTRY GROUPING

[Percent change, annual rate]

Industry	1948–68	1968–73	1973–79
Agriculture, forestry, fisheries	4.8	3.0	2.5
Construction	2.7	—1.8	—2.8
Mining	4.5	1.0	—5.2
Transportation	2.4	2.3	1.2
Communication	5.4	4.3	6.0
Utilities	6.2	2.6	1.0
Wholesale trade	3.3	2.8	0.5
Retail trade	2.7	1.9	0.8
Finance, insurance, real estate	1.9	0.6	0.6
Services	1.3	1.4	0.4
Manufacturing	2.9	3.9	1.5
Durable	2.6	3.0	1.5
Nondurable	3.1	5.1	1.7

Note.—Labor data are based on hours worked.

Source: Gross product originating (GPO) by industry divided by hours worked (table 6.12 and 6.13, National Income Accounts).

TABLE III.—OUTPUT PER MANHOUR

[Percent change, annual rate]

Industry	1948	1968	1973	1979
Agriculture, forestry, fisheries	1.49	3.78	4.38	5.08
Construction	4.15	7.02	6.41	5.40
Mining	5.74	13.77	14.46	10.48
Transportation	4.68	7.47	8.36	9.00
Communication	4.17	11.86	14.65	20.76
Utilities	5.65	18.69	21.21	22.47
Wholesale trade	4.38	8.32	9.55	9.85
Retail trade	2.73	4.61	5.06	5.32
Finance, insurance, real estate	14.97	21.74	22.41	23.19
Services	3.63	4.73	5.06	5.18
Manufacturing	3.87	6.80	8.23	9.02
Durable	4.25	7.11	8.27	9.00
Nondurable	3.43	6.36	8.17	9.05
Total private business	3.76	6.99	7.86	8.35

Source: See table II.

TABLE IV.—PERCENTAGE OF DEPRECIABLE AND OTHER ASSETS AND DEPRECIABLE ASSETS PER EMPLOYEE BY INDUSTRY—1977

Industries	Total assets [1] (millions)	Selected assets, percent of total assets: Net depreciable assets	Inventories	Net depletable assets and land	All other assets	Depreciable assets per employee [2]
Agriculture, forestry and fishing	$27,066	35.5	10.9	25.8	27.8	2.8
Mining	75,247	41.8	6.5	10.0	41.7	38.7
Construction	62,918	27.5	25.0	5.9	41.7	4.5
Manufacturing	1,229,416	31.9	28.0	3.6	36.5	19.9
Transportation	105,650	64.0	3.6	1.7	30.4	25.6
Communication	136,450	82.0	3.2	.4	14.4	96.8
Electric, gas and sanitary services	242,700	84.6	4.3	1.6	9.4	278.6
Trade total	319,926	22.4	42.6	3.3	31.7	3.9
Finance, insurance, and real estate	2,005,564	4.1	.4	1.3	94.2	18.4
Services	101,180	45.3	5.6	6.0	43.1	3.0
Business not allocable	1,270	25.0	25.5	4.9	44.7	([3])
Total	5,654,054	26.5	15.3	2.8	55.4	21.2
Total excluding finance	3,648,490	39.9	23.4	3.5	33.5	21.9

[1] Assets adjusted to net accounts payable against accounts receivable, excludes loans to stockholders mortgage and real estate loans and other (essentially financial) investments.
[2] Units are million dollars per thousand employees.
[3] Not available.

Sources: Office of the Secretary, Office of Tax Analysis, June 9, 1981.

Senator ROTH. Thank you, Mr. Ture.

As you know, there has been a lot of controversy over how much savings will be enhanced by the President's tax package. Do you have any estimate as to what the impact will be and how much of the savings would flow to productive investment?

Mr. TURE. Mr. Chairman, I think that is one of the key questions to be addressed to the tax program and I can offer and will offer you some answers which are I think very encouraging, but I must caution you that until all the facts are in after the program is in, it is still an estimate.

One way of looking at this is to look at it in the abstract. In the abstract, we know that reducing marginal tax rates along with many of the other features in the tax program make it less costly for people to save. Now what will be the response of people to that change in relative costs? If you assume that people are inert and nonresponsive to these changes in costs, then I think you'll have a very difficult time trying to explain the economic behavior in the main. That's the kind of assumption about economic behavior that I think all of us have to reject because in effect it says that we're done forever, we can never learn, and all the evidence is to the contrary.

Watch people in the supermarkets. When they see changes in relative prices they respond to those changes, and if you have any doubt about that personally, all you have to do is ask a manager of a supermarket. Why does he offer a loss leader? Why does he do it week after week? Because he knows it's an effective device.

Well, the empirical evidence reinforces the abstract analytical answer. We have had a substantial amount of evidence about what the response of individuals in their saving behavior is to changes in marginal tax rates. A very dramatic set of evidence was provided in response to the Kennedy-Johnson tax cut in 1964-65. Those were across the board, not quite evenly distributed, but substantial tax rate reductions. They were initiated in two steps. They were not in magnitude as large as those now proposed, but they were substantial.

The personal saving rate in the period prior to the enactment of the Kennedy-Johnson cuts in 1964-65 varied somewhere in the neighborhood of 5.5 to 6.25 percent and for some considerable period back. Immediately following that reduction, in the very first stage, the personal saving rate went up to 6.7 percent, if my memory serves me correctly. In the next 7 years, the personal saving rate was over 7 percent. In 6 of those 11 years, it was over 8 percent. In 1969, if you will recall, we enacted, regrettably, the 10-percent income tax surcharge. The personal saving rate plummeted in response thereto. In 1970 we began to lift the 10-percent income tax surcharge. Our policy error did not stay with us all that long. The personal saving rate immediately and positively responded.

It seems to me both theory and evidence urge on you as strongly as they can that people are indeed not irrational; they weigh the cost of alternatives and they are responsive to changes in those costs. I would hate to sit in judgment on the American public and say they are creatures of habit, nothing but consumption machines, that their response to a material change, one of the most dramatic changes in the history of the income tax, to the cost of savings versus consumption will be nothing whatever. I just reject that outright.

Senator ROTH. I think the case of Japan is interesting. There, I understand, the savings rate is roughly 20 to 24 percent; and I have been told that families can save almost tax-free as much as $50,000 per member of family. I have not had a chance to check into that, but a number of Japanese in my office so advise me.

Mr. TURE. There are a combination of provisions in the Japanese tax law with respect to a family of four where aggregate savings of the returns of the individual will be tax-free in the amount of somewhere a little over $200,000, which comes out to roughly $50,000 per person. If you were to translate that into American equivalent terms, we would be talking about very substantial accumulations of savings and investment, the returns on which we would exclude from the tax base. We envy the Japanese in all sorts of respects, as Congressman Richmond cited any number of cases. Sometimes we fail to be informed and educated by a good example.

Senator Roth. Mr. Richmond made a comment about the importance of better cooperation between labor and management, a matter with which I agree strongly. One of the things that has come up in discussions with some of labor is that if we have this capital formation and modernization of plants, what will the effect be on the individual worker? Are they going to find themselves automated out of a job? In Japan, of course, at least in the large companies they have the so-called "life contract" which has protected them, and basically Japan, by having a fast-growing economy, has been able to continue to provide jobs. I think that's a very important factor here at home. If we want the cooperation of the working people, they've got to understand that they are going to share in the benefits.

My question to you is, Do you see the expansion of the economy into a vibrant growing economy will mean jobs and better opportunities for the working people? We need something like 10 million jobs in the next 10 years.

Mr. Ture. The answer, Mr. Chairman, is clear. There's only one way in which we can provide real honest-to-goodness jobs, and this is by increasing the productivity, by increasing the amount and the quality of the capital with which workers are employed. This fear about automation displacing workers—let me intrude a moment of personal history. I came to the Joint Economic Committee staff in 1955. I had 6 very productive, for me, very growing years on the staff of the committee.

In 1955 we had a series of studies, one of which was on automation, and it was a study that was undertaken by the committee exclusively in response to this fear that automation, which was then a very big thing, was going to create a huge wave of unemployment in the United States; that putting in a machine would take the job away from the worker.

That's a concern that I think has beset people who work with their hands from time immemorial and yet it's never been substantiated by facts. What facts tell you is exactly the contrary. The way in which the average worker gets more assurance about an employment opportunity is by virtue of the fact that his productivity is greater. The method to advance his productivity is the same from the time the Lord evicted Adam and Eve from the Garden of Eden when he told them to be fruitful. He had to give them laws of production. Those laws of production have been with us ever since and, to my knowledge, nobody has tried to repeal them.

What they tell you simply is if you want to increase the productivity of this kind of agent of production, give it that kind of agent of production to work with. We all know that. It's all part of our daily experience. I showed that and demonstrated that to one of my children who was out raking leaves with a rake. We had a power mower that had a mulcher with a bag on it. I said, "I bet you could improve your performance enormously." I hooked up the mower and got it going and she cleaned up the leaves like that. I said, "This is your first lesson in economics, the importance of capital in increasing your productivity."

Well, these examples are with you every place if you want to test it with any randomly selected person who works with their hands. For example, a baggage handler. Tell him to take away his cart and ask him what will happen to his productivity, the amount of tips he can earn per working day. Clearly, you will kill him if you do that. Increasing the capital per worker is the way which assures gain in productivity, assures employability. It's the only way through time that we can in fact provide the basic conditions for the kind of expansion of employment and real wage rates by which the welfare of this country depends. It's that simple.

Senator ROTH. Thank you, Mr. Ture. Congressman Richmond.

Representative RICHMOND. Thank you, Mr. Chairman.

Mr. Weidenbaum went to great extent to say that all or a lot of this has to be done by private industry and not by Government, but in you own testimony you mentioned that productivity has grown more rapidly in the agriculture sector than any other sector of the United States. I think you would agree that Government has involved itself in agriculture productivity considerably more than it has in any other area. Would you say so, Mr. Ture?

Mr. TURE. On a per unit of production basis, that's probably so. I haven't measured it, but I would surmise that's probably true.

Representative RICHMOND. There are 3,500 agricultural extension officers throughout the United States where they actually work with the farmer on productivity.

Mr. TURE. They rate very high on R. & D.

Representative RICHMOND. Maybe that could tell us something.

Mr. TURE. May I interrupt you at this moment?

Representative RICHMOND. Sure.

Mr. TURE. I think one has to avoid blanket assertions that any time Government puts his hand on something it's necessarily bad.

Representative RICHMOND. Right.

Mr. TURE. However, our track record with Government intervention in the performance of the economy is not very encouraging in this respect.

Representative RICHMOND. Except in the agricultural sector.

Mr. TURE. Even there we have had some very unfortunate experiences, as I'm sure you're aware.

Representative RICHMOND. Mr. Ture, I think we all thank the Lord for this great, great opportunity we have to create foreign exchange through the agricultural sector.

Mr. TURE. Sure.

Representative RICHMOND. I don't know where we would be without it right now.

Your comments on depreciation are obviously very, very pertinent. Certainly under the present depreciation laws, any company that wants to even begin to maintain a degree of modernization must spend at least double its depreciation account, and I think the new tax code will probably equalize that, won't it?

Mr. TURE. We're hoping it will. That's one of the President's objectives.

Representative RICHMOND. I believe that's a matter of bipartisan support. I think anybody who knows business knows the depreciation laws in the United States are——

Mr. TURE. Antique.

Representative RICHMOND. Are the most antiquated of any industrialized country in the world.

Mr. TURE. Absolutely.

Representative RICHMOND. Then you mentioned women in the labor force. Let me tell you that women, if given decent quality of life in their factories, decent working environment, are every bit, if not more, productive than men.

Mr. TURE. I have no doubt about that at all.

Representative RICHMOND. You said something about the fact that productivity has gone down because so many women have gotten in the labor force.

Mr. TURE. Let me clarify that. As entrants into the labor force, they did not have substantial prior experience. All new entrants in the labor force, by virtue of that very fact, are relatively low productivity workers unless they have some gift from the heavens and they come fully equipped with all the skills required.

Representative RICHMOND. It doesn't take very much to acquire the skills. Women are much, much better assemblers on small jobs; for example, small power motors. They can outproduce a man 2 to 1.

Mr. TURE. Let me sort of elaborate the statistics and amplify that explanation. There is nothing in the observation I made that is intended to denigrate the productivity of women as women in any kind of job you can think of. On the contrary, what the observation really pertains to is—let me flesh this out. Between 1969 and 1980, those 11 years, in nonagricultural employment as measured by the Census Bureau's establishment figures, there was added to the employment rolls 20¼ million wage and salary workers. Approximately 12 million of them were women. In that same period, those 11 years, the number of additional full- and part-time jobs in manufacturing payrolls was 200,000.

Now it stands to reason and the arithmetic tells you inexorably that very few of those 12 million women who came into the labor force went into the manufacturing jobs. There are a lot of explanations for that. A good number of them were housewives who could not take on full-time jobs unless the wage differential was sufficiently great enough to warrant them doing so. And this was a period during which the rate of productivity, therefore real wage rates, in manufacturing relative to the rest of the economy was decelerating. So we had a combination of circumstances where a very substantial fraction of the new entrants into the labor force into those kinds of employment where the levels of productivity are relatively low.

Representative RICHMOND. Two other slight comments I have to your testimony. You mentioned that many American manufacturers have labored long and unhappily under our many regulations, like our environmental regulations which have taken so much money, and energy costs. I'm sure it's apparent to you that both Germany and Japan have had identically the same problems. Japan has had a much worse energy problem than we have had.

Both Germany and Japan do have very, very strong environmental laws.

So I think our two major industrialized competitors have the same problems we have. So we can't really blame government regulation for cleaning up the air and the water, nor can we blame energy costs, because of our inability to compete with Germany and Japan.

Mr. TURE. No, I would not.

Representative RICHMOND. Our inability to compete is due to productivity.

Mr. TURE. That's right.

Representative RICHMOND. And there again, it's productivity right from the bottom on up, the attitude of the worker, the condition of the equipment, the amount of automation they have—and I agree with you and Chairman Roth, obviously, the more you automate the plant, the better guarantee you have of that worker staying in that plant. I have never seen anybody lose their job because of automation. Invariably, once you automate, you increase your volume and you can use that worker somewhere else.

Mr. TURE. Absolutely. I would say that we have a unique disadvantage with respect to regulation, particularly environmental control regulation though.

Representative RICHMOND. As against Germany and Japan?

Mr. TURE. As against Germany and Japan, but notice that productivity advances have slowed in those jurisdictions as well, not again because of the regulation burden. But I think irrespective of what jurisdiction your regulatory burden comes from, you have to bear in mind that where you get some gains from cleaner air and cleaner water you have to pay for it as well. But our regulatory policy has not been adequate as a measurement of the cost with respect to the gain. The regulatory reform programs that the administration has now initiated is making sure those costs are much more fairly considered in the decision and enter into the decision.

Representative RICHMOND. Thank you, Mr. Ture.

Senator ROTH. Thank you, Representative Richmond.

Representative Rousselot.

Representative ROUSSELOT. Mr. Chairman, I'd like to ask unanimous consent to put in the record just after the discussion on research and development expenditures in leading industrial countries, a table that has been prepared for us by the National Science Foundation which shows research and development expenditures in leading industrial countries as a percentage of gross national product.[1] There was a discussion on that earlier.

Senator ROTH. Without objection.

Representative ROUSSELOT. I think it's right after the testimony by Mr. Weidenbaum.

It is interesting to note that the United States is really not as bad off as indicated by Congressman Richmond. In 1977, the United States devoted 2.3 percent of its GNP to research and development; Germany, 2.3 percent; and Japan, 1.9 percent. So actually the United States is not doing so badly.

Mr. Ture, I compliment you on a very excellent statement on this whole issue and also your recommendations for the solution.

[1] The table referred to may be found on p. 16.

Much of them are what we have before us in the Ways and Means Committee right now, although we are having difficulty with our Democratic colleagues moving on these proposals.

In any regard, I was fascinated by your discussion on the accelerated cost recovery system and reductions in marginal tax rates. We have had complaints by some of our colleagues in the House that these two recommendations in the tax package, the accelerated cost recovery system and reduced marginal tax rates don't really help medium-size or smaller businesses.

Now I don't believe that accelerated depreciation and tax reduction is harmful, but would you comment on this view? Some say, "The tax package is all skewed to big business, the wealth," and all those things. I don't really think that's true, but would you comment?

Mr. TURE. Nor do I. Let me address them in sort of a sequence. Take the marginal tax rate reduction. If you're an unincorporated businessperson, there is no other kind of tax change that's going to be more beneficial to you directly than the marginal tax rate reduction.

Representative ROUSSELOT. That's going to help the small business?

Mr. TURE. It's the individual tax you pay and if you want to pay less of it, one way to do it and a very positive way of doing it is reduce marginal tax rates. A very substantial fraction of the total business community in this country is unincorporated and represents a very, very large proportion of the small business community.

Representative ROUSSELOT. Do you know what percent it is now?

Mr. TURE. No, I don't really, because I don't really know what the small business community population looks like, but I have heard estimates of something like 80 percent or 90 percent.

Representative ROUSSELOT. Right.

Mr. TURE. Beyond that, the marginal rate reductions also ought to have the effect of increasing after-tax rates for workers. Thus, it will reduce upward pressures on pretax wage rates, and that certainly ought to be helpful to the small business.

But what I really want to address is the position of the small businessman with respect to the proposed accelerated cost recovery system. I was a small businessman before I came to the Government, probably the smallest businessman you have ever had in front of you, and it was an extremely labor-intensive operation. But I want to tell you that in terms of advancing the productivity of our operations, nothing in the tax law then was more important to me than the fact that I could have passed through to me by a lease arrangement the investment tax credit and that I could claim, on the equipment that I purchased, accelerated depreciation, for instance. That made it feasible for me to buy word processing equipment, computer terminals, that otherwise would have been prohibitively expensive.

The productivity gains in our operation were enormous. So it is a myth when you hear someone saying that in fact ACRS is not important for a labor-intensive operation. The only way labor-intensive operations' productivity is going to be advanced is by the owners of those enterprises finding ways in which they can use capital facilities to increase their labor force's productivity. These are enormously important tax advantages for them and for the small business community, taken at large, whether it's incorporated or unincorporated, it seems to me they suffer as much as anybody else does from what has happened in the interaction of our antique depreciation system and inflation and they, just as much as anybody else, will benefit from efforts to modernize that depreciation system.

Representative ROUSSELOT. Then the next question is. If the small businessperson or partnership will in fact benefit from these two types of tax reductions, will they use them? Are they likely to use it for reinvestment? We have the claim all the time, "Oh, no, everybody is going to run out and spend it on all kinds of consumer goods. Nobody will save or reinvest." What is your experience as a small businessperson or in your association with others, in whether tax reduction will enhance small business productivity?

Mr. TURE. Well, I don't have any doubts at all about that. I think we're both reasoning about how people behave in response to what the tax system offers them or doesn't offer them, as the case may be, and all statistical evidence being compiled urge that in fact these are going to be very productive, rewarding tax changes, and that we will—I can't give you explicit quantifications of the magnitude of the saving and response, but I'm quite confident that we are all going to be very much impressed by it.

Representative ROUSSELOT. Is there any tracking of investment in response to reductions in capital gains tax?

Mr. TURE. I'm sure you're aware of the interesting reports that have been developed in the last several months with respect to the encouragement of venture capital operations which the reduction in the tax burdens on capital gains in 1978 generated. I think that we have only seen the beginning of that, though the response has been muted by the enormous inflation we have gone through and the 1980 recession; but I have no doubt at all that we are now witnessing much higher levels of personal investment, venture capital undertakings, than we otherwise would have seen. To argue the contrary says, in effect, that people who are prepared to take risks in business ventures do so without any regard to the cost and rewards of those undertakings. I'd hate to think that was true.

Representative ROUSSELOT. Mr. Ture, thank you for being here. I'm sorry but I'm supposed to be on the floor for a vote. That's my best productivity for the day.

Senator ROTH. Mr. Ture, I have a couple of additional questions.

As you well know, there are two different proposals with respect to depreciation—the administration proposal, and the alternate in the House which would allow full expensing of business investment in the first year and a phased-in reduction of corporate income tax from the present 46 percent to 33 percent by the year 1990. How do you think these two proposals stand up against each other?

Mr. TURE. Well, I wish that I were more familiar than indeed I am with the details of this alternative House proposal with respect to expensing. I don't want to deprecate the virtues of an expensing proposal. Ultimately, it seems to me; that is, what we should be looking for as a final test on the effect of the tax system on the saving investment versus consumption choice and choice among all types of capital output. That calls for the expensing or its equivalent, but as between expensing or its equivalent, it makes little difference.

It seems to me what we ought to do is take the type of proposal that is in front of us now as has been widely noted as a very, very close approximation of expensing and go with it. The interesting part of this alternative, insofar as I understand it, is its focus on bringing in reductions in the corporate tax in time, and I think all we can do is to cheer that perception that sooner or later we must make very material reductions in corporate income tax rates. Our ultimate objective is to say goodby to the corporate income tax, but it is not necessarily the single most urgent or top priority on a program agenda of tax changes.

In promoting the ACRS proposal, we focused on what appeared to us to be certainly the most pressing business tax problems and I have tried to develop it in my testimony and to which many, many other witnesses I'm sure will direct their attention. We have had this interaction of the inflation process, raising of inflation costs, with the depreciation system which focuses on historic costs and it has had the sad effect of raising real marginal tax rates enormously.

Incidentally, substituting reductions in corporate tax rates for that is not adequate because it does not address that interaction directly, but we must address that sooner or later, it seems to me, in any constructive program of tax revision. To make the tax system less at war with the market system and make it more conducive to efficient operation of the market system, sooner or later we have to tackle the role of the corporate income tax and I think I have made my premises on that subject clear. I would hope that on our long-range tax program that will have a very high priority.

Senator ROTH. My last question is with respect to R. & D. Under the administration proposal we are extending the tax credit allowance to wages and salaries. The question is, long term, should we extend that to other costs of research?

Mr. TURE. Well, the other major cost of research, the peripheral cost of research, is for capital items, structures, equipment, and so forth, and for those items we have proposed a very accelerated writeoff accompanied by industrial tax credits. I would strongly urge before we propose anything more liberal than that we get an opportunity to see how these two provisions in combination will affect R. & D. activity. As I indicated before, I know of no one who deprecates the importance of the advance of technical knowledge in advancing productivity, but I know very few people can give you a confident explanation of what ultimately determines why our R. & D. advances rapidly this year and slowly next year. One of the things that occurs to me is that there seems to be a fairly close association between the basic R. & D. activity and the rate of increase in capital formation, and I'm not sure what the connection is. But looking at that association very strongly suggests if we do something constructive in the tax code to reduce the tax barriers to capital formation and assume there is a strong response—we are confident there will be—I would be surprised if we didn't get a substantial acceleration of R. & D. activity along with it.

Senator ROTH. Well, thank you very much for coming today and delaying your testimony. I find you always very stimulating and helpful and I look forward to hearing from you again.

Mr. TURE. My pleasure, sir.

Senator ROTH. Now I'd like to call on an old friend, a part-time Delaware resident, who has served the Government for many years and has played a major role as an individual thinker and an individual who always has provocative ideas. Mr. Breecher, welcome to our subcommittee.

STATEMENT OF CHARLES B. BREECHER, ADVISER ON TAX POLICY, REPUBLICAN NATIONAL COMMITTEE

Mr. BREECHER. Mr. Chairman, I greatly appreciate this opportunity to testify. In my prepared statement, and the introductory remarks, I want to concentrate on items which may have not been given sufficient consideration so far because I think that will be of most value to this subcommittee and the Congress. One of the reasons why they have not been given sufficient consideration is some of the things I'm going to say may not be all that welcome to certain perceptions of our own wealth and position in the world.

First, I would like to say that this subcommittee is rightly concerned how changes in our tax laws will affect capital formation, savings rates, trade and economic growth, including probable effects on individual manufacturing sectors and obviously, in the Congress, there will be a great deal of pressure by various industry groups to get some special consideration.

While I'll be glad to attempt to answer questions on who's going to benefit most or who might benefit least, I did not think it advisable to treat these questions in my prepared statement because they have already been ably dealt with by Government witnesses. But second—and this is the part which I don't think has been considered sufficiently—investment and savings decisions can seldom, if ever, be traced to tax policy alone. Instead, one should look at the effects of the President's whole program, including prominently budget reductions and regulatory changes and monetary restraint. Third, and again you see the point which I don't think is being made sufficiently, it's wrong to assume under present circumstances and particularly in the United States that investment decisions are governed solely by economic considerations. Psychology, and other noneconomic considerations, play a very great role also, and that's unfortunately true particularly for decisions of foreign governments which play already an enormous role and a much underestimated role for the U.S. economy, a development which I view with a little bit of alarm.

But let me stress that the President's program is very good economics. As you know, I'm very familiar with the way it has evolved and why it can only be beneficial for jobs and living standards, but there are some conditions. First, it must be adopted with reasonable speed. Second, it must be adopted as a long-term program, 3 years being the absolute minimum; and next, it must not be whittled down so it becomes ineffective. Then I would like to make another point which I think has not been stressed sufficiently, although Mr. Ture referred to it here at the end—Roth-Kemp—and I'll call it by the right name—is the greatest conceivable help for small business because small business is mostly organized either in individual proprietorships or as partnerships or if it's incorporated it's under so-called subchapter S corporations, and all of these pay income tax at the individual rates. So small business really gets a double whammy out of the President's program: one, the liberalized depreciation; but second, reduction of individual income taxes.

So on this point I would like to say that the President's program is good economics and an indispensable first step. But as a second indispensable step—and that's what I want to bring to the attention of this subcommittee—it will be necessary to stop redistributing our own income and wealth around the globe. We have been engaged in this process for decades now, with disastrous results for ourselves, and almost unnoticed by most Americans. In my prepared statement, I refer only to two major, very visible programs which are beggaring the United States and that is foreign aid and private investment overseas, but there are others, although they may fall somewhat outside the jurisdiction of this subcommittee—paying OPEC blackmail, illegal in international law, and providing the defense of other countries which they could and should provide themselves.

There's been a good deal of references to Germany and Japan in this session. Well, one of Germany's and particularly Japan's great advantages is that we provide their defense. The Japanese premier told us that he didn't want to put money into defense; let the United States provide it. He wanted to put it into investment for Japanese business.

While I'm on Japan and Germany, one other point was raised by Mr. Richmond. He said that regulation was as strict or maybe stricter in Germany and Japan than in the United States. That's basically true, but a tremendous difference is that if you have a regulatory decision by the executive branch in Germany or Japan, that's it. You don't have these things, which are the worst about U.S. regulation in my humble opinion; namely, these 5- or 10-year lawsuits which you never know how they're going to come out but which double or triple the cost of your plant. That's probably the worst part of our regulations and something should be done about it.

To come back to my major theme, though, that we are engaged in redistribution of wealth and assets around the world—and I give you some instances in my prepared statement—I would like to close with a major illustration to show the extent to which the United States has become a debtor nation. The Washington Post recently published some holdings by Kuwait in many U.S. major corporations. Maybe the size of these figures—and I hope, Mr. Chairman, some of the members of the subcommittee read it—came as a shock to some members of this subcommittee. They mentioned $7 billion and there was a mention Kuwait accounted for $33 billion in trading on the New York Stock Exchange in 1980.

Now to put that in perspective, that's approximately 1 month's trading on the New York Stock Exchange. So the Kuwaitis account for a little less than 10 percent of trading already.

Now comes the most important point. These figures are not the Kuwait holdings by any means. Those are the figures for the

Kuwait Investment Corporation which is only one part of all the accumulated Kuwait holdings and with one bank, Citicorp.

Against this, I would like to quote a little story in the Wall Street Journal of the 18th of May which talked of the Kuwait Finance Minister—of course, nobody paid any attention—saying that Kuwait had over $60 billion, not $7 billion—$60 billion stashed away in cash equivalents, with two-thirds invested in the United States. So that would be for this one small OPEC country of 250,000 citizens, $60 billion which are invested which they hold over our heads in the United States.

So what I want to say to this subcommittee and to the administration is that our foreign economic policies might have been affordable for us 20 years ago. They have become outdated and counterproductive and positively ruinous, and our legislation, primarily tax legislation, makes the United States act like a country that desperately wants to export its excess savings and excess accumulated capital, when in reality we desperately need to save and invest more right here at home. As a part of that process, we must stop letting ourselves be exploited right and left and most of it illegally, and I use that word—I'm a lawyer, too, in international law—very advisedly, that we let ourselves be exploited illegally by other countries who don't even proclaim to be our friends and allies.

Well, Mr. Chairman, one little piece of testimony that's not going to change the policies of the U.S executive branch and of the Congress, but I do think its high time that this problem be addressed before it becomes completely unmanageable.

Let me give you just a last illustration of our own State of Delaware. Our Governor has just been traveling around to Europe, London in particular, and France, and, of course, he's trying to get investments into the State of Delaware and the others are doing the same. He particularly talked to the London bankers and told them how good the Delaware banking laws are. It's true. Yet it seems a little silly when we have all these 14,000 banks I believe in the United States that a Governor has to go out and try to attract foreign banks. So there's something fundamentally wrong. It's not enough to just get more savings for the United States. That's the President's program. That's right and it's good. But then, the savings must be invested in the right place. Otherwise, it's not going to do one bit of good.

[The prepared statement of Mr. Breecher follows:]

Prepared Statement of Charles B. Breecher

Mr. Chairman, I greatly appreciate this opportunity to testify. I shall concentrate on a major subject that has so far not been given sufficient consideration by Executive Branch and Congress: the harmful effects of excessive spending abroad, by both Government and the private sector.

First, however, let me stress that the best thing the Congress can do as a first priority is to pass the President's economic program, and in particular this tax reduction program. That will go a long way to restore U.S. economic health and productivity. And the same as the 1980 Republican Platform does, I shall call the tax reduction program by its right name, namely Roth-Kemp. This does not take away any credit from President Reagan, who has consistently strongly endorsed Roth-Kemp since 1978.

Anything less than the President's total program of tax reductions, expenditure reductions, cutback in regulations and slower growth of the money supply just won't do the job of bringing about the desired changes in the savings and investment habits of the public and of business.

One major point is pertinent here. Roth-Kemp has been criticized as doing too much for individuals and not enough for business. That's totally inaccurate, because Roth-Kemp is the greatest possible help for small business. Small business is mostly organized as single proprietorships, partnerships and Sub-Chapter S corporations. All these pay income tax at individual rates, not at the corporate rate. And it's small business, not the big corporations, that creates more than half of the new jobs and is the driving force in innovation.

So enacting the President's economic program is rightly the first priority for the Administration. But then there are other changes in our economic policies that have to be made, in part through legislation, to make the program a success.

The chief purpose of the President's economic program is to bring forth more savings, more investments and more jobs, all in the U.S. private sector. But if the increased savings we rightly expect are again channelled abroad by our Government and big business, the multinationals (MNC's) as happens now on a large scale, they won't do the U.S. economy much good, if any.

For the U.S. Government spending abroad the money it borrows mostly from the savings of the private sector, foreign aid is the major cause. It takes many, many forms and no one can say just how big our foreign aid is, because that depends on definitions. But under the rather restrictive criteria used by A.I.D. (Agency for International Development), U.S. Foreign Aid was $7.8 billion in fiscal year 1977, $9 billion in fiscal year 1978, $13.6 billion in fiscal year 1979, and about $10 billion in fiscal year 1980. For a country with a large budget deficit, large trade deficit and large balance of payments deficit which must cut back sharply on various domestic programs, these figures are simply shocking, in my view.

Now please do not get me wrong. Whatever our own financial troubles, I strongly advocate continuation of our humanitarian aid, because there human lives are at stake. And particularly that humanitarian aid which prevents people from having their throats out, such as military aid to Israel. That's the most humanitarian aid of all! But humanitarian aid, properly defined, is only a small proportion of our total aid outlays.

For all other U.S. aid, the burden of justification is on those who propose it, within the Executive Branch and then to the Congress. And here it is just not good enough to cite these hollow phrases: "national interest, geopolitics, preserves peace, strengthens friendly Governments, wins friends, good for our exports, morally right," and so on. Usually, these have no backing whatever from the past record. Instead, for each aid program it will have to be shown that it serves a concrete, I repeat concrete, U.S. military economic or political interest, and this concrete U.S. interest justifies giving the program priority over U.S. domestic needs that must be cut back.

I trust that the overwhelming majority of Americans, in and out of Government, would agree that in our present financial circumstances, the aid criteria I suggest are simply common sense. But under them, few aid programs other than humanitarian aid properly defined, would qualify. An intellectually sensible case might be made for aid to El Salvador. But aid through the IBRD and the other misnamed development banks? Aid to Syria, Jordan, Zimbabwe and the like?

The aid constituencies, consisting chiefly of the big banks and the self-serving bureaucracy, know that they have no case in cold logic. So they first claim wrongly that various aid programs, for instance contributions to the IFIs, are untouchable as alleged "U.S. commitments". That's simply untrue. All U.S. commitments are made conditional on subsequent appropriations which the Congress is free to make or not to make. Art. I, Sec. 9 Cl. 7, U.S. Constitution.

Second, a preferred tactic seems to be not to ask for appropriations at all but to rely on a Continuing Resolution. That one may be tied to items that simply must be passed, so various aid programs escape the examination re: budgetary priorities.

And then certain aid programs are financed without the taxpayer and apparently others than a few bureaucrats knowing about it. I refer to the astounding practice of our Treasury to turn over cash to the IBRD and others, long before it is needed, then effectively to borrow the money back from the people we have given it as a grant in the first place and to pay interest on our own money. The IBRD for instance seems to have about $12 billion in cash equivalents on hand, mostly in the form of U.S. Treasury IOUs which it is busily trading for even greater profits. Returning to what is normal U.S. budgetary practice of granting drawing rights only, to be used when the money is actually needed for the purpose appropriated, would save hundreds of $ Millions annually for our budget.

Now to the private sector and its foreign spending. Here we have tax laws and environmental laws plus certain advantages for imports, granted by foreign Governments mostly, which give business every incentive to invest and reinvest overseas and not to repatriate profits. But surely this process is less beneficial to the U.S. economy in terms of creating jobs here and re-industrializing America than if the same money were invested in the U.S.

I am unable to discern what Americans genuinely profit from these overseas outlays in many cases, except for some corporate executives whose bonuses are tied to reported per share earnings. Benefits to the shareholders are somewhat illusory because non-repatriated profits cannot be paid out in dividends. American workers obviously lose out, compared to equivalent domestic investment. So does the U.S. Treasury. Indeed in some sectors, particularly banking and oil, our large corporations pay far more to foreign Governments than they pay to the U.S. Treasury.

Now one can't in fairness criticize U.S. business here. It just does what our own Government gives them every incentive to do. And again our self-serving Government bureaucracy has thrown up smokescreens so that our outdated laws and policies should not be questioned.

First, the bureaucracy claims that flexible exchange rates take care of any U.S. balance of payments problem in short order. That's patently untrue as shown by the record. If inter-country transactions were governed by market forces, it would be true. But many such transactions, I estimate more than half, are not governed by market forces, and certainly not by a free market.

There is a second allegation to show that there is no problem. We are told that the U.S. "current account balance" has become slightly positive. That's a grossly misleading statement. This so-called "current account balance" is a hopeless, meaningless mish-mash and completely inaccurate even under its own spurious definitions.

What I refer to here is Table A-52 in the Federal Reserve Bulletin. It shows substantial deficits in the U.S. current account balance for 1978 and 1979, but lo and behold, 1980 shows a "surplus" of $718 Million. Now is that not wonderful?

Well, please consider the following:

(1) There is an ever-growing "statistical discrepancy". For 1980, it's $35 billion, I repeat $ billion.

(2) An enormous amount, also growing, is included in inflows as earnings from private investments abroad, whether repatriated or not. But we know from the corporations' annual report that they do not ever intend to repatriate the bulk of these earnings in many cases. Mobil Corp. is an example.

(3) U.S. Government financed exports are included in trade exports, though that's aid, not trade and helps our statistics only, not our balance of payments.

What I recommend to the Administration and the Congress is the main on private investments abroad is the following:

(1) Get yourself a half-way decent set of figures which show what we actually sell, buy, earn, pay out, borrow and lend each year, as a Government and in the private sector. And roughly what a balance sheet of Governmental and private assets and liabilities shows.

(2) Reverse the rule for overseas profits. Tax non-repatriated profits, make repatriated profits tax-free.

(3) Treat all overseas taxes as an expense of doing business there, the same as we treat corporate income taxes paid to our own states.

Mr. Chairman, let me sum up. The first priority in attempting to improve U.S. productivity is to pass the President's program, and Roth-Kemp in particular. Next, make sure that the increased savings of the American people are invested here. That will require major changes in economic policy and legislation.

I hope I have drawn attention to an important, hitherto somewhat neglected subject. I shall now be happy to answer any questions.

Senator ROTH. Mr. Breecher, I wonder if you would review for the record, our practice of turning cash over to the IBRD, a practice that enables the Bank to make profits of hundreds of millions of dollars, according to your estimate.

Mr. BREECHER. All right, Mr. Chairman. I would like to offer for the record an article which appeared in the Wall Street Journal as well which showed that the IBRD was the biggest trader in U.S. securities. It's a story that was tucked away on page 25—and most people I presume didn't get the significance of it—of the Wall Street Journal on the 30th of March, and here it is. It shows that the IBRD had about $12 billion in cash on hand and was using this cash first to earn more interest and, second, to use it to trade back and forth in U.S. securities. Now this is incredible. We are giving the IBRD—we are turning over cash to them and then we borrow it right back from them in the form of securities, and now we pay interest on our own money at the rate of 13 or 15 percent when they obviously don't need the money. This is just financing another foreign aid program without knowing it.

[The article referred to follows:]

[From the Wall Street Journal, Mar. 30, 1981]

SPECIALIZED BREED OF TRADER MANAGES WORLD BANK'S HUGE POOL OF ASSETS

(By Daniel Hertzberg)

WASHINGTON.—Philip Spray, who grew up on a farm outside Pittsburgh and spent four years in the Peace Corps teaching dirt-poor Brazilians how to organize farm cooperatives, says he "thought it would be interesting to see how the big boys play."

Today, Mr. Spray is a big boy, playing with $2 billion in a portfolio of foreign government securities and bank certificates of deposit. He's one of six international traders who manages one of the larger pools of liquid assets outside the Organization of Petroleum Exporting Countries, the $9.7 billion short-term portfolio of the World Bank. In the 12 months ended in February, the traders earned a total return of 13.47% on short-term dollar assets.

By telephone from a small room deep inside the World Bank headquarters a few blocks from the White House, Mr. Spray and his colleagues quietly hobnob with other traders and bankers in London, Bonn and New York. "Discretion is the key with them," a New York trader says.

TRADERS WHO THINK

Morton Lane, president of the financial futures trading firm of Discount Corp. of New York Futures and himself a former World Bank trader, says, "There are lots of excellent traders around who don't think and lots of excellent thinkers who can't trade. What they"—the World Bank's officials—"have done is to try to find the rare breed that can do both." John J. Gutfreund, managing partner of Salomon Brothers, New York, says, "I find them as hard-driving and professional as any operation I've seen."

As the World Bank staffers, the praise is understated. They're not only better than Wall Street's fear- and greed-ridden traders, they say, but they also work for less money.

Owned by the governments of 135 countries, the World Bank is better known for its long-term borrowing in international capital markets than for its short-term trading. Its method is to borrow largely in nations such as Japan and West Germany, where interest rates are usually low, and relend the money to poorer nations. (The bank's long-term lending policies have long remained controversial, and there's talk in the Reagan administration of cutting U.S. support for the bank.) As of Sept. 30, the bank's outstanding debt amounted to $29.7 billion, up from $12.3 billion in 1975. By shepherding a big pool of liquid assets, the bank can avoid borrowing in the bond markets when interest rates are unusually high and money tight.

GETS IMMEDIATE GRATIFICATION

To manage the cash, the bank has assembled an elite group of traders and economists. Few fit the Wall Street mold, Hani K. Findakly, 35 years old, who manages the bank holdings of U.S. government securities, has advanced degrees in science and engineering from the Massachusetts Institute of Technology. As a civil engineer he spent three years building an airport and other projects in Iraq, his native land. "If you're an engineer, and you design a dam, it takes 20 years to see the benefits," he says. "In here, you get immediate gratification"—or something, because a trader can as easily lose $100 million in a few weeks as he can gain that much.

Other traders come from Germany and Peru. Most of the traders hold advanced degrees in science or economics. If they "weren't at the bank, they'd be teaching in a university, or they'd be major industrialists," says Eugene H. Rotberg, vice president and treasurer of the bank.

The bank's trading proceeds under tight discipline partly because of its policy of taking no risk on currency fluctuations. (Its borrowers, however, necessarily take currency risks.) That means, for example, that for every German mark it borrows, it must have lent out or bought short-term securities for an equivalent amount of marks. In its liquid-assets portfolio, at least, the bank shuns high-interest credit risks. To preserve its pool, it must rely on correctly forecasting major moves in interest rates rather than on the leveraged, day-to-day money-market speculation of the typical Wall Street financial trader.

REQUIRES MOVING QUICKLY

That sometimes means buying and selling shorter-term securities to reduce the average maturity of its portfolio from as long as four years to as short as two weeks, at a time when short-term rates appear ready to head unusually high relative to longer-term rates, or to reverse the process when the move has peaked. But the bank's portfolio is so huge it can't change course quickly. Traders must anticipate rate changes and move before the rest of the market.

Some 70 percent of the portfolio is typically invested in dollar securities, such as Treasury bills and notes, bank deposits and overnight bank loans, because only the dollar market is big enough to provide sufficient liquidity.

Wall Street traders typically try to guess interest rates as far ahead as "10 minutes to two hours" in the future, says Hugo J. H. Schielke, a tall, pipe-smoking banker from Germany who works as the bank's chief investment officer. By contrast, the bank's economists must estimate rates three months ahead for the U.S. and other major industrial countries in order to trade portfolio securities in the direction of rate changes. "We try to get the big move and put a large amount of money behind it," Mr. Schielke says. By large he means between $500 million and $2 billion.

The bank's computers, programmed with mathematical models of financial risk, churn out optimum securities mixes based on interest-rate assumptions to provide the highest possible return for the least risk. Traders then try to sell and buy securities at the best prices available. The computers also monitor prices in international securities markets to flag profitable price anomalies.

It was much simpler in the old days before 1971, when U.S. wage-price controls, the elimination of gold as a standard for settling international debts, and a spurt in interest-rates and inflation began to change the nature of cash management. Back then, Mr. Schielke says, "There was an old Chinese and his secretary who rolled over time deposits"—that is, renewed bank deposits at maturity. "Occasionally Gene Rotberg sent a cable to the Federal Reserve to buy some government agency bonds."

Last year, the bank's traders turned over $150 billion in 9,000 transactions. In Treasury bills, the average trade ran between $25 million and $50 million.

Traders sit around a cherrywood desk beneath digital clocks giving the hour in important financial capitals. Philip Spray chats on the phone, sometimes in German, sometimes in French; he also speaks Portuguese. Messrs. Schielke and Findakly debate the merits of two-year Treasury notes versus bills maturing in a year or less. "I'm going to buy 250," Mr. Findakly decides, and a bid goes into the Fed's weekly auction for $250 million in three-month bills.

CITE LOW PAY

Although successful traders on Wall Street may earn much more, the traders get more than the minimum wage—$28,000 to $50,000, after taxes, because the bank also pays them an amount sufficient to cover their income tax. Still, the staff blames low pay for the exodus of three experienced traders in recent years. One of them, Mark Winkelman, now a vice president at Goldman, Sachs & Co., says his salary more than doubled when he left the bank. Just a few days ago, John Hill, who oversees day-to-day trading operations, submitted his resignation to join Merrill Lynch & Co.'s Merrill Lynch International. Mr. Hill is a former Federal Reserve staffer.

Unable to outbid Wall Street for experienced hands, the bank concentrates on recruiting and training younger candidates with academic backgrounds. The bank offers them time to teach and pursue research. That makes it "a very nice environment" to work in, says Mr. Winkelman. It's "totally the opposite of Wall Street."

Indeed, the bank doesn't even pay a yearly bonus, a sacrosanct practice on Wall Street. But Mr. Rotberg turned off an otherwise ebullient convention of bonus-flush traders in Boca Raton, Fla., last fall when he taunted that they could never match the skilled performance of his Ph.D.s. The reason, he said, is that the Wall Streeters worry too much about job security and compensation; his more modestly paid traders remain free to exercise their best intellectual judgment, untainted by greed. The other system, he says, makes "bad traders out of smart people."

The traders suffer other frustrations. Mr. Findakly complains that "we trade so much money, but to get an extra secretary. Another typist or a research assistant is next to impossible." Some traders think the department is seriously understaffed. Mr. Schielke chafes at the bank's unwillingness to expand its conservative trading into financial futures contracts, as Wall Street firms have done. Says Mr. Rotberg: "The reason we aren't in futures isn't the bureaucracy of the bank. It's me. I'm not convinced that's necessary for the bank at this time."

Mr. BREECHER. Now for my life, I cannot see why we don't treat the IBRD and the other interregional development banks the same as we treat our own Government departments. The Pentagon gets appropriations for $200 or $150 billion but it doesn't mean the Treasury turns the check over to the Pentagon and they invest it in U.S. Government securities and get another $30 billion for free as interest. They get drawing rights on the U.S. Treasury.

Now we're doing the same thing with the IBRD. If we think it is in our interest, which I doubt very much—but suppose we do—to turn cash over to finance these foreign aid programs, then all we should do is say, "Well, when you need the money when your working fund of $12 billion is down to $1 billion," which I think is quite respectable, "then you can draw on the U.S. Treasury with your check, but in the meantime we are not going to give you more cash so you can lend it back to us and then we can pay interest on it." I hope I have made myself clear.

What struck me particularly was after this story appeared nothing whatsoever happened. Everybody thought this was perfectly normal.

Senator ROTH. Do you know when this practice started?

Mr. BREECHER. It's been the case all the time. The IBRD and others, of course, say they can't make any loan even if they pay it out in 10 years. They have to have the cash in hand first. Well, I don't see why that should be so.

Senator ROTH. Do they do this in other international areas? Are the other banks contributing to it, for example?

Mr. BREECHER. I'm not sure I understand your question.

Senator Roth. Well, for example, do we provide money to other international banks?

Mr. BREECHER. Yes, we do the same thing. To the best of my knowledge, we do the same thing with the Asian Development Bank and—well, the Asian Development Bank is a story in itself—and I don't know that this is quite as bad there. This is only one case, but, of course, in foreign aid I say we do this with other people too. What we are doing on a very large scale, for instance, is provide cash to countries whose foreign exchange reserves are going up merrily, and what they do, of course, with the cash which they don't really need, at least at this point, is mostly invest it again in U.S. Government securities. Jordan is a pretty good example of this. It can be even worse. In the case of Indonesia, Indonesia is the biggest speculator in gold. Indonesia accounts, which are somewhat bigger than our aid, have been invested by Indonesians in buying gold. So far they have lost their shirt on it, but that's another matter. But surely, that's not a very good case for turning cash over to them.

Senator Roth. I noticed in your prepared statement that one of your recommendations would be that we reverse the rule for oversea profits which gives business every incentive to invest and reinvest overseas and not to repatriate profits. Has any country done that?

Would that have a negative effect on our balance of payments?

Mr. BREECHER. It would have the most positive effect on our actual balance of payments, not in these measurable figures which are being published which are completely misleading, as I tried to point out in my prepared statement. What does a balance of payments have to do? Mobil Oil at one time, I read, had $1.6 billion which they had permanently invested abroad and, of course, it provided no provision for U.S. income taxes because they never want it to be repatriated. I'm asking what does the U.S. economy—what does anybody in the United States get out of this except some corporate executives of Mobil Oil whose bonuses are tied to the reported share earnings? The stockholders don't get anything out of it. You can't pay dividends out of profits which you reinvest forever. The only time stockholders get something out of it, I presume, is when they're expropriated and they can use it as income tax deduction to the extent that Mobil pays any corporate income taxes.

Senator Roth. You raised several questions I would like to explore with you. Unfortunately, the hour is late for a policy discussion, but I would like to talk to you further about these recommendations. I appreciate your being here and your coming here and giving us the advantage of your testimony. As I say, you're always innovative and sometimes controversial. Thank you very much.

Mr. BREECHER. Thank you. Mr. Chairman, if this is controversial, then I would very much like you to know why I have made this presentation several times within the Republican National Committee and the reaction was always the same—one long silence and then afterward maybe I'd get a letter from Alan Greenspan saying, "I agree with you." But, of course, that's the way I am. I always say, "Well, does anybody disagree with me and what's to argue with?" Of course, there wasn't anything.

Mr. Chairman, there's one thing which I would like to add. It won't take more than a second.

Senator Roth. That's fine.

Mr. BREECHER. Senator Abdnor raised the question of the stock exchange jitters. As a private investor myself, I would like to assure him that this has been vastly overdone by the press. It is true that every time the Dow Jones goes up over 1,000 then it seems to be dropping back again, but these are decisions made very largely by corporate managers who want to make a little money and who have standing instructions that when it goes above 1,000 sell and when it goes to 950 buy. But generally, particularly the smaller stocks are doing very, very well, and it's not true that the business community does not support the President's program.

Thereto, on the 11th of May, corporate executives expressed strong support for the Reagan plan to cut personal income tax over 3 years along with the business tax cut. The business community is very strongly supporting the proposal the President has put forth, said the board chairman of Citicorp of New York. This is quite important because it's being said over and over again that the business community is not happy with the President's proposal. Certainly things are never good enough, but generally they are quite happy.

Senator Roth. I want to thank you for your help in promoting and developing the tax package. Your advice has been very helpful, and we will be in contact with you on the foreign aid problems you raised. Thank you very much, Mr. Breecher, for coming back to Washington on a hot, muggy day.

The subcommittee stands adjourned.

[Whereupon, at 1:05 p.m., the subcommittee adjourned, subject to the call of the Chair.]

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