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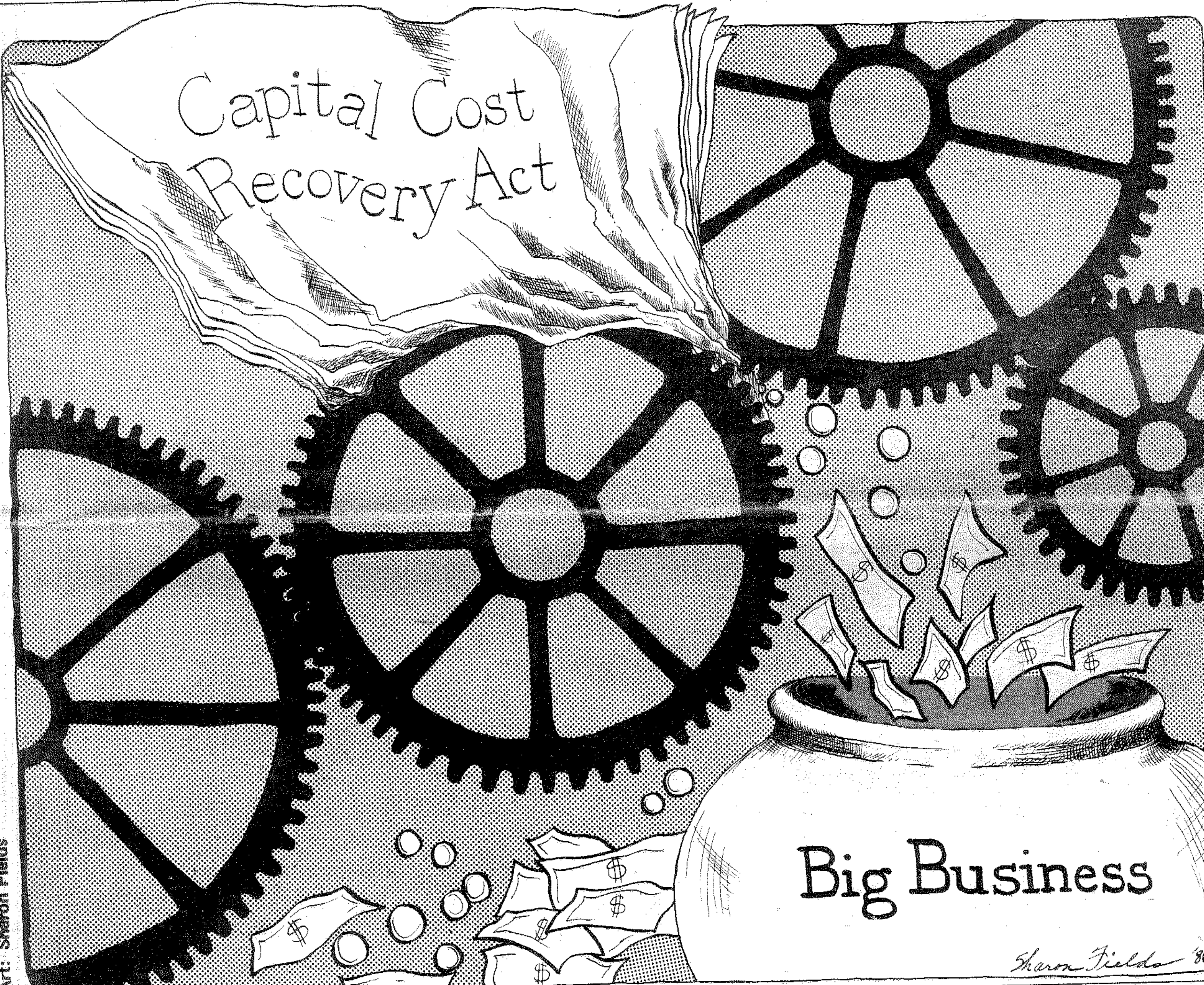

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10-5-3 — Business Bonanza?

Corporate lobbyists seek repeat of 70's policies

by Robert S. McIntyre

Remember the windfall profits tax? It's only a few months since it was enacted, but Congress already seems to have forgotten its pledge to return the revenues recaptured from the oil companies to help individual taxpayers cope with skyrocketing energy costs. Instead, our representatives appear determined to use all the windfall tax collections and much more to finance the largest corporate tax cut ever.

Last fall, we reported to you that, "Believe It or Not, Rep. Barber Conable and James Jones think the tax treatment of oil companies is so fair and reasonable that they want to extend the same favorable treatment to all U.S. corporations." We were referring to the "10—5—3" depreciation bill, a plan to cut corporate taxes in half by tremendously speeding up tax write-offs for investments in equipment and buildings.

In spite of our best efforts, proposals to gut the corporate income tax through faster write-offs have taken off in Congress. By the middle of August, 10-5-3 gained some 310 co-sponsors in the House (out of 432 current members) and 55 co-sponsors in the Senate (out of 99 Senators), including a majority of both the Senate Finance and House Ways and Means members. Among the more recent converts were tax reform apostates like Representatives Joseph Fisher (D - Va.) and Richard Gephardt (D - Mo.) and Senator George McGovern (D - S.D.) Pressed with the need to develop a "Democratic alternative" after Republican candidate Ronald Reagan endorsed 10-5-3, the Finance Committee has already approved its own depreciation speed-up plan. Called 2-4-7-10-15-20, this somewhat less generous version of the Republican plan has already been praised by Mr. Reagan.

Even the Carter administration, which came into office with a strong commitment to tax reform, has adopted the big business line. Although the administration severely criticized 10-5-3, especially after the Reagan endorsement, President Carter's latest "new economic policy" asks Congress to approve depreciation speed-ups which will cost Treasury some $24 billion a year by 1985.

At this point it's all but certain that Congress will pass some form of huge corporate tax cut late this year or early next year. For partisan reasons it will probably be one of the Democratic rewrites of the 10-5-3 plan. And the result is likely to be disastrous for already overburdened individual taxpayers.

The enthusiasm in Washington for massive corporate tax cuts -- also endorsed by independent candidate John Anderson -- represents a striking victory for what has to be the biggest and best orchestrated business lobbying effort ever.

- Focusing tax changes on investment incentives and "supply-side" economics is a major change in direction for federal tax policy.
- The U.S. investment rate has become dangerously low in recent years, and more capital investment is the answer to our productivity growth problem.
- Our chief foreign competitors allow much more generous tax breaks for business investment than we do.
- Corporate tax rates have become too high due to inflation.

"Brain washing" is a term not to be lightly bandied about, as former Michigan Governor George Romney learned to his sorrow in 1968. But the success of the business lobbyists in bringing so many politicians and economic pundits into the corporate camp comes at least close to meriting the appellation. Through saturation lobbying and frequent pieces in friendly publications like *Business Week*, *The Wall Street Journal*, and *Time* magazine, the corporate apologists have made the following items part of the popular wisdom in the nation's capital:

Together, these statements make up most of the supporting case for 10—5—3 and similar depreciation proposals. But if they are subjected to analysis, it is clear that *none* of them are true.

New Wave Economics?

Perhaps the most ludicrous claim made by the corporatists is that a focus on business subsidies and "supply side" economics represents a radical change in direction for tax policy. In fact, nothing could be further from the truth, and it is mind-boggling that so many important people in Washington seem to believe this contention.

During the past decade, each time individual tax rates were adjusted to offset the effects of inflation, there was an accompanying *real* cut in business taxes, primarily focused on providing "supply-side" incentives. In 1971, the Nixon administration sought and obtained enactment of the ADR system of accelerated depreciation, which shortened depreciation lives—and upped depreciation write-offs—by 20 percent. The Nixon package also included enactment of a 7 percent investment tax credit for purchases of new equipment (a similar credit had been repealed in 1969) and the export subsidy DISC, which exempted from taxation half the profits from exporting. Then Treasury Secretary John Connally promised the Congress that these "supply-side" changes "will provide jobs and income for workers and will foster the greater productivity that promotes price stability and rising living standards for all Americans."

When these "supply-side" tax cuts failed to revitalize the economy sufficiently further attempts followed. In 1975, depreciation deductions were further liberalized and the investment credit was increased to 10 percent. In 1978, the top corporate rate was cut, the lower rates graduated, and the investment credit expanded and made permanent. The result has been to cut effective corporate rates by about 30 percent, and

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What is 10-5-3?

The Capital Cost Recovery Act would scrap the current depreciation law, which generally require that business assets be written off only as they wear out, in favor of much faster write-off rules. Under the bill, investments in non-residential buildings could be written off in 10 years—with about 75 percent of the deductions in the first five years—and most equipment purchases could be written off over five years—with 84 percent of the deductions in the first three years. (Investments in cars and small trucks could be written off over three years- with 89 percent of the deductions in the first two years.) In contrast, under current tax rules and standard financial accounting procedures 25- to 50-year write-off periods are typically assigned to buildings and 5- to 35-year periods are used for various kinds of equipment.

The effect of such changes would be to increase depreciation deductions enormously, and consequently to reduce taxes on corporations dramatically—perhaps by as much as 50 percent within a few years. Even ignoring the effects of the investment tax credit, current law already yields tax write-offs of about 25—30 percent per year in excess of book depreciation. The Capital Cost Recovery Act would add at least 20 percent over current write-offs meaning that long-run tax depreciation would be more than 50 percent higher per year than book deductions. And the short-run effect is likely to be even greater.

Furthermore, when the 10% investment tax credit is factored in, 10-5-3 actually yields greater tax benefits in many cases than immediate full write-offs, or "expensing." Since expensing is the theoretical equivalent of eliminating the taxes on all but windfall income from capital investments, the result of 10-5-3 would be to take whole industries off the tax rolls and yield *negative* tax rates on some kinds of corporate investments. In other words, rather than taxing corporate income, the government would be *paying* corporations to earn profits. And when debt-financed investment is involved -- as is usually the case -- the negative taxes can become even larger. □

to reduce the share of Treasury revenues supplied by corporate taxes from 19.5 percent in fiscal 1969 to an estimated 12.9 percent in fiscal 1981. At the same time, of course, individual rates have remained about constant, supplying about 45 percent of budget receipts, and social security taxes have increased enormously, from 21 percent of receipts in fiscal 1969 to 32 percent in fiscal 1981.

Overall, the "investment incentive" tax cuts of the 70s (not even including the corporate rate cuts) added $22 billion a year to the tax subsidies for business purchases of plant and machinery—bringing the total cost of such tax breaks to a staggering billion a year. (Total corporate loopholes come to $47 billion a year.)

In light of the historical record, it is both mysterious and depressing how the corporate lobbyists have managed to convince so many members of Congress that repeating the tax policies of the 70s represents a bold new plan.

Productivity Growth, Inflation, and the U.S. Investment Rate

The primary argument put forward in support of faster depreciation is that it would result in a dramatic increase in investment which would lead to a dramatic improvement in the rate of growth of productivity. In spite of the fact that the level of business investment has been close to its all-time high as a percentage of GNP for the past two years (even not counting investments in pollution control equipment), supporters of faster write-offs argue that their measures are needed to spur even more investment. They point to the decline in labor productivity gains in the 1970s, and maintain that only a surge in capital spending to higher levels than ever before can revitalize our economy. Without this intensified investment, they contend, our future standard of living will be too low.

Growth rates of national income, national income per capita, and national income per-hour worked, 1948–73, 1973–78, and 1975–78
(in constant prices)

	1948–73	1973–78	1975–78
National income	3.7%	2.1%	5.2%
National income per capita	2.2%	1.4%	4.3%
National income per hour worked	2.7%	0.7%	1.9%

SOURCE: Derived from Denison, *Accounting for Slower Economic Growth* (1979).

"Productivity" is a word much bandied about these days, and many who use it seem to believe it synonymous with human happiness. In fact, it means much less. Simply put, the productivity of a given input, say labor, is equal to the dollar output of the economy divided by the quantity of the inputs, say hours of work. It is important to note what productivity does not include: For example, advances that permit new and better final products to be provided do not contribute to productivity growth as it is actually measured. Non-monetary benefits, such as cleaner air or safer products, do not show up as productivity gains. Many other things which are important to us, individually and as a society, are irrelevant so far as productivity is concerned.

In spite of these serious deficiencies, productivity growth is one useful tool in measuring the advances the economy makes over time. As the following chart illustrates, national income per hour worked increased at an average rate of 2.7 percent per year between 1948 and 1973, and then the growth rate dropped precipitously in the mid-70s, to only 0.7 percent per year from 1973 to 1978. Much of this decline was, of course, due to the major recession in 1974 and

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Capital Formation in the U.S. Economy
(Business Fixed Investment Relative to GNP)

	(1) Nonresidential Business Investment/GNP	(2) (1) less spending on pollution & abatement/GNP		(1) Nonresidential Business Investment/GNP	(2) (1) less spending on pollution & abatement/GNP
1953	9.4		1968	10.3	10.2
1954	9.3		1969	10.6	10.4
1955	9.6		1970	10.2	10.0
1956	10.4		1971	9.8	9.5
1957	10.5		1972	10.0	9.6
1958	9.3		1973	10.4	10.0
1959	9.3		1974	10.7	10.3
1960	9.4		1975	9.8	9.4
1961	9.0		1976	9.7	9.3
1962	9.1		1977	10.0	9.6
1963	9.0		1978	10.4	10.1
1964	9.4		1979E	10.7	10.3
1965	10.4		1980E	10.6	10.2
1966	10.8		1981E	10.6	10.2
1967	10.3	10.2			

E = DRI forecasts.

As part of their campaign for faster depreciation write-offs, the corporate lobbyists have been inundating Congress with an seemingly impressive array of charts and tables. Apparently, their strategy is to assume that no one will actually bother to examine their data, since more often than not the statistics they present actually contradict the conclusions they are supposed to buttress. Here are two examples:

I. International Comparisons

The following chart compares the tax depreciation systems used by the U.S. and most of our major trading partners. As can easily be seen, the U.S. provides for faster write-offs than most foreign countries, in particular Japan and Germany, the two countries whose economic records have been most impressive.

Yet the advocates of 10–5–3 frequently reproduce this table in their congressional testimony as evidence that the U.S. depreciation system is too slow compared to those of our competitors!

II. The U.S. Capital Investment Rate

The 10–5–3 advocates frequently produce tables purporting to show that U.S. "capital formation" has been dropping off in recent years. For example, Allen Sinai of Data Resources, Inc. included the following chart in his testimony before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, and told the Subcommittee that it showed that the investment/GNP ratio, "aside from a burst in the early 70s, currently reflects a lower ratio than previous peaks." Mr. Sinai went on to say that "the periods of most rapid formation of capital, 1962 to 1966 and 1975 to 1977, were associated with relatively strong performance in productivity and improved results on inflation." Unfortunately for Mr. Sinai's analysis, however the chart he purportedly relies on completely contradicts his statements.

As a close look at the chart shows, the average investment/GNP ratio from 1962 to 1966 was 9.7, well below the 10.4 ratio in the late 60s when productivity growth started to fall. The ratio in the 1975–1977 period was 9.8 (or, not counting pollution control equipment, 9.4). This is significantly less than the 10.2 (9.8) ratio over the entire 70s, and even further below the 10.6 (10.2) ratio in 1978–1980. The alleged "burst" in the early 70s was actually below the ratio for the entire decade as well.

Country	Percentage of the cost of representative asset recovered: In first year	In first 3 years	In first 7 years	Ranking number
United Kingdom	100.0%	100.0%	100.0%	100
Canada	60.1%	108.3%	108.3%	99
Sweden	48.2%	86.2%	118.2%	96
United States	**42.8%**	**72.5%**	**104.7%**	**84**
Italy	25.0%	75.0%	100.0%	79
Japan	37.2%	66.6%	96.8%	77
France	31.3%	67.6%	94.6%	75
Australia	30.0%	50.0%	90.0%	68
Germany	25.0%	57.8%	86.7%	67
Belgium	26.0%	54.8%	86.3%	66

SOURCE: First three columns from Price, Waterhouse, March 28, 1979. Ranking numbers are derived from the Price, Waterhouse data based upon discounting out-year deductions. Small differences in ranking numbers are insignificant. The higher the ranking number the faster the cost recovery.

Having fun in Finance

Congressional wheels usually turn slowly, and one hopes they would turn both slowly and carefully on tax cut legislation that would affect all of us. But Capitol Hill committees do move quickly upon occasion, especially when political mileage is to be made by doing so. A case in point is the Senate Finance Committee which has acted with blinding speed in reporting its tax cut proposal.

According to Article 1, Section 7 of the Constitution, "all bills for raising Revenue shall originate in the House of Representatives." The reason for this requirement was that the House members, with their frequent elections, were considered closer to the people and therefore less likely to ignore the public's interest in enacting tax legislation. But the farmers failed to reckon with Long's Law of Taxdynamics: "For every rule, there is an equal and opposite loophole."

And so, it was with some merriment that an almost unanimous Senate Finance Committee added a $39 billion tax cut as an amendment to a minor House-passed bill to suspend the duty on six bronze Swiss bells for the Foundry United Methodist church of Washington, D.C. When the knee-slaps and guffaws subsided, it was apparent that the real joke was on individual taxpayers.

The measure, approved by the Finance Committee on a 19—1 vote, confirms the constitutional framers' fears about Senate-originated tax legislation. Average taxpayers will get little or no real tax cuts, after accounting for inflation-caused "bracket creep" and next January's social security tax hikes. But the bill provides a 25 percent corporate tax cut, mostly in the form of faster depreciation write-offs, and expands several loopholes worth millions to the wealthy. Only Senator Bob Packwood (R—Ore.), who fears that the trend toward cutting taxes on investment income could lead to a national sales tax, voted against the bill.

Because the size of the tax cut is substantially larger than most members of Congress want, it's likely that the individual tax cuts will be scaled down even further on the Senate floor. The situation is reminiscent of what

Russell Long

happened to tax cut legislation in 1978 when Senator Long and others insisted on huge reductions in capital gains taxes and business taxes—which meant that individual reductions were trimmed down until they did not even offset inflation, except for those earning more than $50,000 a year.

Thus, in spite of Congress' promise to use the windfall profits tax revenues to provide substantial, real income tax cuts to help people cope with skyrocketing energy costs, most individuals will actually have to face both higher energy prices *and* higher taxes.

Specifically, the Finance Committee's amendment includes the following:

Business and Investment "Incentives"
($17 billion in 1981, $33 billion in 1985)

2—4—7—10—15—20 depreciation—A $10 billion increase in annual business investment subsidies (rising to $20 billion in 1985), this provision is a scaled-down version of the Republican 10—5—3 plan. It would allow depreciation write-offs for equipment at least 20 percent faster than under current law, by shortening the write-off periods to 2, 4, 7, or 10 years (and retaining the existing accelerated formulas). Factories, stores, office buildings, and other real estate could be written off over 15 years using an accelerated formula if occupied by the owner. Other buildings could be written off over 20 years using a straight-line method (15 years for low-income housing) at the taxpayer's option.

According to staff reports, the idea was to eliminate taxes on investments in equipment lasting 12 years or less, but to avoid the *negative* tax rates which the 10—5—3 plan would create.

Rate reductions—The top corporate rate would be reduced from 46 percent to 44 percent over two years, and the rates on the first $200,000 of corporate income would also be cut, at a total cost of about $4 billion when phased in.

Research and development—An additional subsidy for research and development would be provided, in the form of a 25 percent tax credit for R & D spending in excess of the average spent for this purpose in the three preceding years. The cost of this would be about $500 million a year.

Investment tax credit—The current 10 percent investment tax credit for rehabilitating existing industrial and commercial structures would be increased to 25 percent.

Capital gains—The exclusion for individuals would be increased from the current 60 percent to 70 percent, so that only 30 percent of the profits from selling real estate, stocks, bonds, or other capital assets would be subject to tax. This would cut the maximum rate on such income for even the highest income taxpayers to only 20 percent. Eighty percent of the $2.4 billion revenue loss of this provision would benefit the three percent of taxpayers with incomes exceeding $50,000 per year. The tax on corporate capital gains would also be reduced, from the current 28 percent to 20 percent, a $300 million change which would primarily benefit timber companies (much of whose ordinary income is treated as "capital gains").

Employee stock ownership plans—A tax credit would be provided for up to one percent of a company's payroll if the funds are used to set up a stock ownership plan for employees. This would be an alternative to the current rule, which allows one percent of a company's investments in equipment in a year to qualify for such a credit. The cost would be about $2 billion when fully phased in.

Individual retirement accounts—Limits on individual retirement accounts would be increased from $1,500 to $1,750 for individual taxpayers, and from $1,750 to $2,000 for couples. Employees covered by an employer plan would be eligible to set up retirement accounts and contribute up to $1,000 per year. The cost would be about $600 million per year.

Americans working abroad would be allowed to exclude the first $50,000 of their income from U.S. taxes if they work in developing countries, or if their work is charitable, export-related, or natural resource-related. The exclusion would increase to $65,000 after a person has been overseas for two years. The provision would leave most Americans abroad exempt from U.S. taxation, at a cost of $300 million a year.

Individual Tax Changes
(Net reduction: $1.1 billion in 1981)

Tax increases due to inflation-caused "bracket creep" and scheduled increases in social security payroll taxes add up to $22.1 billion. However, the Finance Committee bill offers these offsetting reductions:

Rates would be reduced in all tax brackets by one to three percentage points, including a reduction in the lowest rate from 14 percent to 12 percent, and a lowering of the highest rate from 70 percent to 67 percent.
$12.8 billion.

The personal exemption would be increased from $1,000 per individual to $1,100.
$4.8 billion

The zero bracket amount (or standard deduction) would be raised for single persons from the present $2,300 to $2,400, and for married couples from $3,400 to $3,600. In conjunction with other provisions, this would increase the level below which no income tax is owed to $4,400 for singles, $5,800 for childless couples, and $9,600 for families of four.
$1.5 billion

The earned income credit for low-income families with dependent children would be increased from 10 to 11 percent, with the maximum credit going to $550 from the current $500. The credit is now phased out as income rises from $6,000 to $10,000. The bill would phase it out between $7,000 and $11,000.
$600 million

The "marriage tax"—The extra tax paid by two married persons over what they would pay if they divorced, would be reduced, but only for couples in which both spouses work outside the home. The provision would allow a tax deduction of five percent of the first $30,000 in earnings of the lower income spouse in 1981. A 10 percent deduction (maximum of $3,000) would be provided for 1982 and thereafter. *$2.7 million in 1981.*
About $5.5 billion in 1982.

1975, and predictably, the growth rate improved substantially after 1975. The growth of national income per capita also declined in the mid-70s, although less seriously—the difference being due to the fact that a higher percentage of the population was working for pay.

The causes of the decline in productivity growth are currently the subject of much debate. Lester Thurow, in his recent book, *The Zero-Sum Society*, blames in roughly equal measure: idle plant capacity resulting from government anti-inflation policies; a shift in the mix of goods and services being demanded and produced to services (largely health care); and particular problems experienced in three industries—mining, construction, and utilities.

Edward Denison, associate director of the Commerce Department's Bureau of Economic Analysis, and (according to *Business Week*) probably the country's leading expert on productivity, is less sure of the culprits after analyzing the data in his recent study *Accounting for Slower Economic Growth*. But both economists are convinced that insufficient capital investment explains little, if any, of the problem.

Thurow notes, "Plant and equipment investment cannot explain the decline because it is up, not down. When our productivity was growing most (1948–65), plant and equipment investment averaged 9.5 percent of the GNP. Productivity growth fell after 1965, but investment rose to 10.2 percent of the GNP from 1966 to 1972. Productivity growth took another fall after 1972, despite the sharpest post-World War II recession. . . . [D]eclining investment is not the source of our problems."

Denison points out that the growth of capital per worker has been remarkably stable in the post-war period, and that "there was no adverse change after 1973 that could account for the sudden drop" in the productivity growth rate. He attributes only 0.1 percentage point of the drop in productivity growth after 1973 to a decrease in capital investment in plant and equipment per person employed.

Carter's carrot and stick

President Carter's new tax program employs a carrot and stick approach. The carrot is held out to businesses, in the form of a $16 billion tax cut for 1981, rising to $39 billion in 1985, mostly in the form of new "incentives" to invest in plant and equipment. The stick is applied to individuals, for whom a proposed $12 billion "cut" is far less than the tax increase which will result next year due to inflation and social security tax hikes. In fact, individuals will be left with $9 billion in net tax increases in 1981, rising to $60 billion by 1985. Only when a real individual cut has been "earned" by a lessening in the inflation rate can real tax cuts for average taxpayers be considered, the President declares. Previously this year, of course, he had promised to use some of the revenues from the windfall profits tax to provide real tax cuts to help people deal with skyrocketing energy costs.

The business depreciation changes in the Carter package appear to be similar both in design and cost to the 2-4-7-10-15-20 plan approved by the Senate Finance Committee. Each would shorten tax write-off periods substantially, although the administration would retain a somewhat larger number of categories of plant and equipment -- 30 for Carter versus 7 for the Finance Committee. The cost of the Carter depreciation plan would rise from $6 billion in calendar 1981 to $22 billion in fiscal 1985. The Finance Committee plan would go from $10 billion to $20 billion over the same period. The entire cost in the first 5 fiscal years would be slightly higher under the Finance proposal, $74 billion versus $67 billion for Carter. Each would represent about a 17% corporate cut by 1985.

The Carter Bill includes another $3.5 billion in corporate cuts by making 30% of the 10% investment tax credit refundable for companies which owe no taxes (perhaps because of the new accelerated depreciation write-offs), and authorizing additional credits for investments in depressed areas. The Finance Committee adds about the same amount by cutting corporate rates, but this latter change increases in cost much faster than the Carter-proposed refund ($6 billion versus $3 billion by 1985).

Other similarities between the two programs include reductions in the "marriage penalty," increases in the earned income credit, and tax cuts for Americans working abroad (slightly less generous in the administration version). The Carter package does not include Finance-approved measures like cuts in capital gains taxes, added Employee Stock Ownership Plan credits, and expansion of individual retirement accounts.

The details of the Carter package are as follows:

Business and Investment Tax Cuts ($15.8 billion in 1981, $39 billion in 1985)

"Constant Rate Depreciation" -- Basically a compromise between current law and the Republican 10-5-3 depreciation plan, this proposal would add $6 billion to business investment subsidies in 1981, rising to $ 24 billion in 1985. It would allow depreciation write-offs for equipment and buildings to be as much as 40% faster than under the present rules.

Investment tax credit -- The plan would allow companies which have no taxable income (perhaps due to the depreciation changes just mentioned) to obtain a tax refund for 30% of the investment tax credits they generate. (The remaining credits would be applied to prior or subsequent tax years.) The idea is that, since the 10% investment credit is supposed to be a subsidy, a company that's just starting or is in financial trouble ought to be able to take advantage of it just like profitable companies. In addition, the Carter plan would authorize the Commerce Department to designate up to $10 billion a year in investment projects that it thinks need help to be eligible for a 20% investment tax credit instead of the usual 10%. (The extra 10% would be fully refundable.) *Cost: $3.5 billion.*

8% Social Security Credit -- Businesses would be granted an 8% credit on their share of social security payroll taxes. The size of the credit was chosen to just about exactly offset the scheduled increase in payroll tax rates this January (from 6.13% to 6.65%). The hope is that much of this cut will be passed on in lower prices, thereby helping in the fight against inflation. In the longer run, the cut will probably at least partially result in higher wages.

Small business relief -- Small "Subchapter S" corporations, which are taxed basically the same as partnerships, could have 25 shareholders instead of the current limit of 15. In addition, certain costs of starting up a new business, which now are not deductible, could be written off over 5 years. *Cost: $200 million.*

Americans working abroad would be allowed to exclude the first $25,000 of their income, plus 60% of the next $60,000, if they work in countries officially designated as ' "hardship areas." These would include, for example, all of the Middle East nations, but would not include Europe, Bermuda, the Bahamas, Hong Kong, Rio de Janeiro, or South Africa. This $200 million proposal was made in response to heavy lobbying by multinational companies and their employees.

Individual Tax Changes

(Net increase: $9.4 billion in 1981)

Tax increases due to inflation-caused "bracket creep" and scheduled increased in social security payroll taxes add up to $22.1 billion.

Offsetting reductions in the Carter proposal.

8% social security credit: Individuals would be allowed a tax credit for 8% of their share of social security payroll taxes. This would offset next January's rate increase for those with sufficient income tax liability to utilize the credit. *Cost: $6.2 billion.*

Earned income credit: The refundable earned income credit for low-income families with dependent children would be increased from the current 10% of the first $5,000 of earnings to 12%, and the credit would be phased out between $7,000 and $11,000, instead of between $6,000 and $10,000. This change would more than compensate these families for the increase in social security tax rates in January, but would provide no help to low-income single people. *Cost: $900 million.*

The "marriage tax" -- the extra tax paid by two married persons over what they would pay if they divorced -- would be reduced, but only for couples in which both spouses work outside the home. The provision would allow a tax deduction of 10 percent of the first $30,000 in earnings of the lower income spouse. *Cost: $4.7 billion.*

There's no question that replacement of workers with more efficient machines has historically been one of the major factors in boosting labor productivity—along with improvements in "soft" technology and advancements in worker skills. But the other side of the coin is that worker productivity *suffers* when machines become *less* efficient, and that is exactly what happened as energy prices shot up in the 1970s. And unfortunately, the recent OPEC price increases and the decontrol of domestic oil prices are going to reduce the efficiency of machines even further (at least in the short run), and labor productivity will again suffer.

In the face of higher energy prices, it is, of course, necessary for businesses to become more energy-efficient. Quite rationally, they have already moved quite far in this direction—using machines that require less energy and placing greater reliance on labor. This has mitigated the effects of higher energy prices, but the fact remains: We are less rich because of the OPEC cartel's actions than we otherwise would be.

The case for proposals like 10—5—3 seems to be largely based upon the premise that changes in the tax laws can reverse the effects of higher energy costs. In fact, however, most of the tax breaks would go to reward companies for doing what they would have done anyway. And, as economists Alan Auerbach and Dale Jorgensen have pointed out, much of the impact on investment the bills would have "would be dissipated through misallocations of the resulting capital stock. The misallocation would be much more serious than under the existing tax law," and would be harmful to our need for more efficiency and less waste.

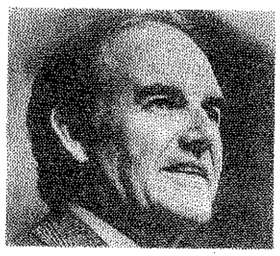
For example, 10—5—3 would tilt business spending decisions in favor of equipment purchases, even where the labor, materials, and energy necessary to construct and operate a machine would utilize more of society's resources than would hiring workers. Excessively costly durable machines would be favored over less sturdy, more cost-effective ones, because the bill's flat five-year write-off period favors machines with long actual lives. And perhaps most significantly, real estate would attract more capital, and equipment purchases less, because the bill grants its largest breaks to investments in commercial buildings.

Even many of the proponents of the bill admit the problem with faster write-offs for real estate. *Business Week* notes that it "could be the best tax shelter opportunity to come along in years, . . . a tax bonanza for real estate speculators." Since *nobody* claims there's currently a shortage of tax incentives for putting up commercial buildings, why were faster write-offs for buildings included in the bill, since real estate subsidies are fundamentally inconsistent with the sponsors' putative goal of encouraging investments in equipment? The answer, of course, is that the real estate break was necessary to win the support of retailing and service industries—companies like Sears, Roebuck. "Politically, everybody had to get something," the draftsmen of the bill have admitted.

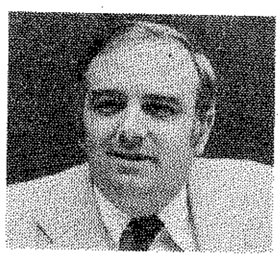
The willingness of the lobbyists for the 10—5—3 to include real estate within the bill indicates how little they really care about or believe in the alleged economic benefits of their plan. Their main goal is simply to reduce taxes on large corporations, that is, on their clients.

Fifty-one tax reform apostates

With friends like these . . .



McGovern



Aspin

Pepper

Hart

House and Senate Members with good to excellent tax reform records who are co-sponsoring the 10—5—3 depreciation bill

	1975—1979* Public Citizen Tax Reform Rating
House:	
David E. Bonior (D—MI)	100%†
Frederick W. Richmond (D—NY)	100%
Joseph L. Fisher (D—Va.)	100%
Les Aspin (D—WI)	94%
Matthew F. McHugh (D—NY)	94%
Claude D. Pepper (D—FL)	93%
Chris Dodd (D—CT)	88%
Andrew Jacobs, Jr. (D—IN)	88%
William Lehman (D—FL)	88%
Jerry Patterson (D—CA)	88%
Berkley W. Bedell (D—IA)	82%
James Blanchard (D—MI)	82%
Floyd Fithian (D—IN)	82%
Norman Y. Mineta (D—CA)	82%
John F. Seiberling (D—OH)	82%
Frank Thompson, Jr. (D—NJ)	82%
John D. Dingell (D—MI)	81%
Robert W. Edgar (D—PA)	76%
Lee H. Hamilton (D—IN)	76%
Harley Staggers (D—WV)	76%
Nick Joe Rahall II (D—WV)	73%
Edward P. Beard (D—RI)	71%
Butler Derrick (D—SC)	71%
Jim Lloyd (D—CA)	71%
Mike McCormack (D—WA)	71%
Edward J. Patten (D—NJ)	71%

	1975—1979* Public Citizen Tax Reform Rating
Edward J. Markey (D—Mass.)	70%†
Harold Johnson (D—CA)	69%
Norman F. D'Amours (D—NH)	65%
Don Fuqua (D—PA)	65%
Thomas R. Harkin (D—IA)	65%
John W. Jenrette (D—SC)	65%
Stephen L. Neal (D—NC)	65%
L. Richardson Preyer (D—NC)	65%
Clement J. Zablocki (D—WI)	65%
Adam Benjamin (D—IN)	64%†
Norman D. Dicks (D—WA)	64%†
Richard A. Gephardt (D—MO)	64%†
Jim Mattox (D—TX)	64%†
Charles Rose III (D—NC)	62%
John G. Fary (D—IL)	60%
Peter H. Kostmayer (D—PA)	60%†
Gunn McKay (D—UT)	60%
Morgan F. Murphy (D—IL)	60%
SENATE:	
Gary Hart (D—CO)	83%
George McGovern (D—SD)	83%
Patrick J. Leahy (D—VT)	81%
Max Baucus (D—MT)	74%**
Gaylord Nelson (D—WI)	68%
Thomas F. Eagleton (D—MO)	62%
Ernest F. Hollings (D—SC)	59%

* Absences not counted in computing percentages.
† Score is for 1977—79.
** Elected to the Senate in 1978. 1975—78 votes are in the House.

Comparisons with Other Countries

The proponents of faster write-offs are fond of pointing to the depreciation rules in other countries as examples of how "antiquated" our approach of trying to measure net income accurately is. Some other countries *do* allow faster equipment write-offs, but the comparative data actually show how little either the depreciation rules or the ratio of investment to GNP relates to relative rates of economic growth or productivity gains.

The United Kingdom, for example, allows immediate expensing of capital investments, yet its economic growth and productivity gains are well below ours, while its inflation rate is worse. Japan's high growth rate has occurred in spite of the fact that it raises a higher share of its government revenues from taxes on capital than does the U.S. Germany's admirable economic performance has been achieved with much slower capital write-offs than ours.

A study done for the Joint Economic Committee in late 1977 by Edward Denison found that "[i]n no case where growth rates of the United States and another country differ considerably does capital account for as much as two-fifths of the difference. Usually, it accounts for much less than that, and in important cases for none at all." Denison also notes that the prices of machinery and equipment compared to other components of GNP have been lower in the U.S. than anywhere else, and when GNP for other countries is restated at U.S. prices, the U.S. actually has the *highest* ratio of non-residential structures and equipment to GNP of any country in the world.

Denison's study concludes that "[w]e should not try to provide more generous investment incentives because some other countries may do so. We should not imagine that investment would be raised radically if we did. And we should not imagine that the growth rate of output would jump up to foreign rates if investment could be so raised."

In his more recent study, *Accounting for Slower Economic Growth*, Denison illustrates how the decline in U.S. productivity growth since 1973 has been shared by most foreign countries. Looking at manufacturing output per hour in the U.S. and six large foreign countries, for example, "all except Germany experience an unambiguous drop in the [growth] rate [after 1973]. The drop was less than in the United States in France, and larger in Canada, Japan, Italy, and the United Kingdom.

High Corporate Tax Rates?

Measured as a percentage of the pre-tax income they report to their shareholders, corporate tax rates have been steadily declining over the past decade. As already noted, the share of government spending paid for by the corporate income tax has plummeted from over 19 percent in 1969 to under 13 percent in fiscal 1981. The effective corporate tax rate on domestic income has declined from about 35 percent in 1969 to only about 25 percent today. In his latest corporate tax study of 100 of our largest corporations, Congressman Charles Vanik (D—Ohio) found that the effective U.S. tax rates on the worldwide income of these companies fell from 27 percent in 1969 to under 19 percent in 1978.

Under any of these measures, the trend in corporate taxes has clearly been downward. But the lobbyists claim that inflation has seriously distorted the measurement of corporate income, and pointing to two recent studies, maintain that corporate rates are actually too high today. Both studies, however, are incredibly flawed, and their conclusions are simply wrong.

At the outset, it should be clearly understood that inflation *can* distort the measurement of investment income, as is painfully obvious to anyone who has a savings account. A primary effect on the corporate side from inflation is a reduction in the value of depreciation deductions. A machine or building is purchased with "real" dollars, while the write-offs in later years can be in deflated ones. But there are two major factors which counterbalance the damage caused by inflation: first, the many corporate tax breaks in the Internal Revenue Code; and second, the income *gains* when inflation reduces the "real" value of debt liabilities (a gain with which anyone who owns a mortgaged home is familiar).

Incredibly, however, the two inflation studies touted by the corporate lobbyists fail to include either of these offsetting factors. One analysis by Martin Feldstein, president of the National Bureau of Economic Research, found that corporations were paying close to $20 billion a year in extra taxes due to inflation—but failed to note that this amount is dwarfed by the $47 billion in corporate tax subsidies alone. (See *P&T*, October 1979, for a fuller analysis of the Feldstein study.) A more recent report by Price, Waterhouse & Co. was even more distorted, using a methodology which, for example, would show Gulf Oil's 1979 tax rate as 73 percent, instead of the 9.4 percent actually paid, and J. C. Penney's tax rate as 87 percent, instead of 19 percent! (See box.)

The thrust of the lobbyists' inflation argument is that faster depreciation would help offset inflation and yield a fairer measure of corporate income for tax purposes. The ludicrousness of such a contention is illustrated by the fact that their favorite proposal, 10—5—3, could actually take many very profitable industries—oil and utilities, for example—entirely off the tax rolls, and even yield *negative* tax rates for some investments.

continued on page 10

GROWTH RATES IN MANUFACTURING OUTPUT PER HOUR

	1950—1960	1960—1973	1973—1978	Drop in average growth rate after 1973 from 1960—1973 period: Percentage Points	% Decline
United States	2.1%	3.2%	1.7%	−1.5%	−47%
Canada	3.7%	4.6%	2.5%	−2.1%	−46%
Japan	9.3%	10.0%	3.5%	−6.5%	−65%
France	4.8%	5.7%	4.8%	−0.9%	−16%
West Germany	6.2%	5.5%	5.1%	−0.4%	− 7%
Italy	5.8%	7.2%	2.6%	−4.6%	−64%
United Kingdom	2.1%	3.9%	0.2%	−3.7%	−95%

Accounting for Inflation

Price, Waterhouse's misleading methods

In May of this year, the Price, Waterhouse & Co. accounting firm issued a report purporting to analyze the data on inflation-adjusted income which is available in 1979 corporate annual reports. The widely reported study concludes that after inflation is taken into account, "real" corporate incomes and returns on investment were much lower than reported to shareholders, and that tax rates were much higher. A look at the methodology used in the study, however, shows it to be ridiculous, and makes one wonder whether Price, Waterhouse can ever by trusted. Specifically:

● The study found that "real" income was substantially lower than reported income after adjusting depreciation and other deductions for inflation—only 60 percent of reported income, for example, for industrial corporations. But the figures in the study ignored the income *gains* experienced by most companies from inflation's reduction in their real debt liabilities—although this information also is included in the annual reports. As the study itself was forced to admit in its text, if those gains had been included, "real" income "would have been higher for all industries except the financial companies, and in several instances, would have exceeded 100 percent of historical [reported] income."

● In calculating "effective tax rates," the study included both "current taxes"—that is, the taxes actually paid—and "deferred taxes"—that is, the taxes which were sheltered by tax subsidies like accelerated depreciation. Such an approach yields grossly inflated "effective tax rates" which are essentially meaningless. To illustrate, the 10—5—3 depreciation plan, which would cut corporate tax liabilities in half, would have no effect on "effective tax rates" as computed by the Price-Waterhouse method.

● Finally, the effective tax rates used in the Price, Waterhouse study are not U.S. federal taxes on domestic pre-tax income. Instead, they include all the income taxes paid on worldwide income. This means that state and local income taxes are included, and more important, that high foreign tax rates can distort the findings substantially. This latter factor is most significant for the oil industry, whose foreign "taxes"—or royalties—are frequently at 60 or even 80 percent rates.

To illustrate the magnitude of the distortions which the Price, Waterhouse methodology results in, here are a few examples:

● In 1979, Gulf Oil paid $104 million in U.S. federal, state, and local income taxes on its domestic pre tax income of $1,103 million—for an effective U.S. tax rate of 9.4 percent. Under the Price, Waterhouse approach, the focus would be on Gulf's pre-tax worldwide income of $3,082 million. Added to the $104 million in current U.S. taxes would be $267 million in "deferred" U.S. taxes, $10 million paid to Puerto Rico, and $1,379 million in current and deferred foreign taxes. This would yield an "effective rate" of 57 percent—even before inflation adjustments.

Then, Price, Waterhouse would reduce Gulf's reported income by $673 million to allow for the effects of inflation, primarily on depreciation write-offs. But it would ignore an offsetting *gain* of $421 million due to inflation adjustments to debt. The Price, Waterhouse result would be to show Gulf with "adjusted" pre-tax income of $2,409 million, and an "effective tax rate" of 73 percent!

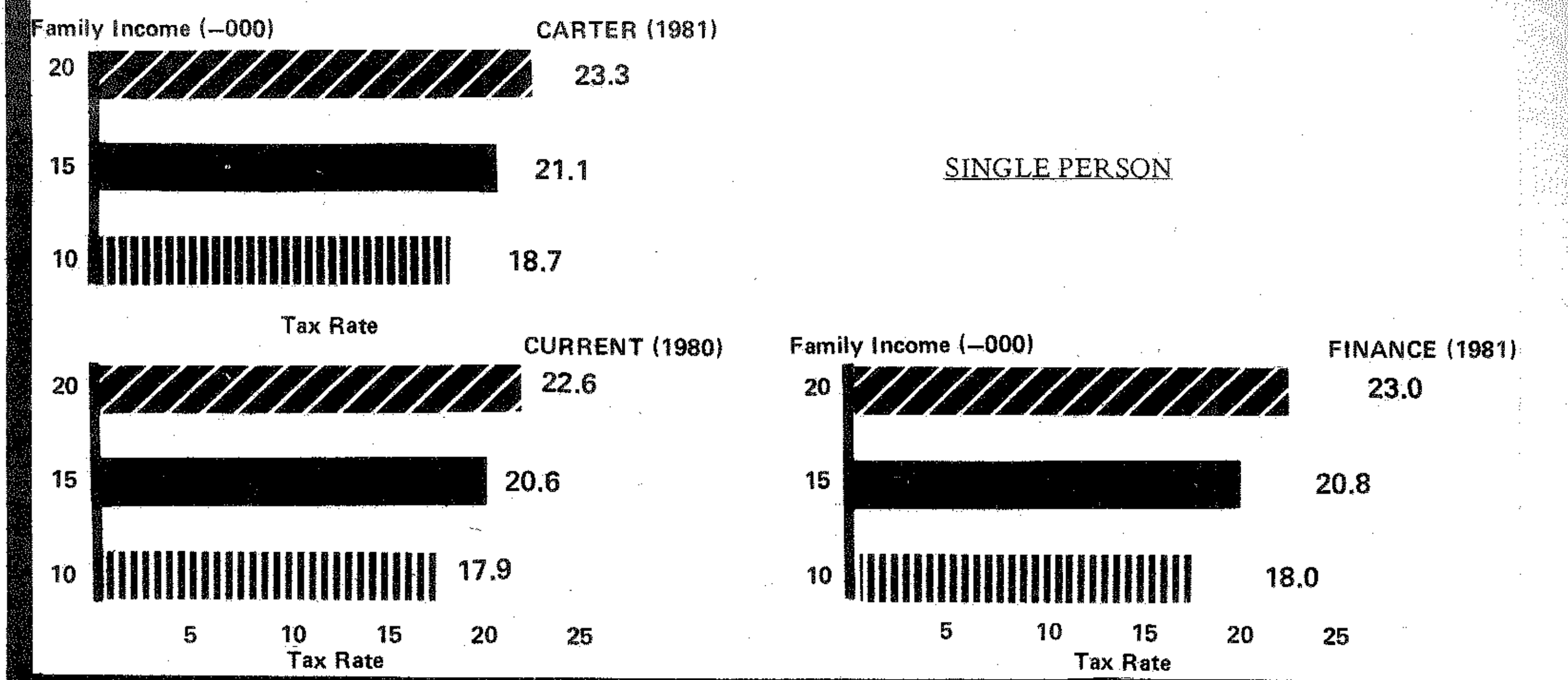
If the calculations are done properly, the result is substantially different. Adjusting the U.S. pre-tax income of $1,103 million for inflation's effects on both depreciation and debt reduces it by only $140 million—to $963 million. This changes the current effective tax rate by only 1.4 percentage points, from 9.4 percent to 10.8 percent.

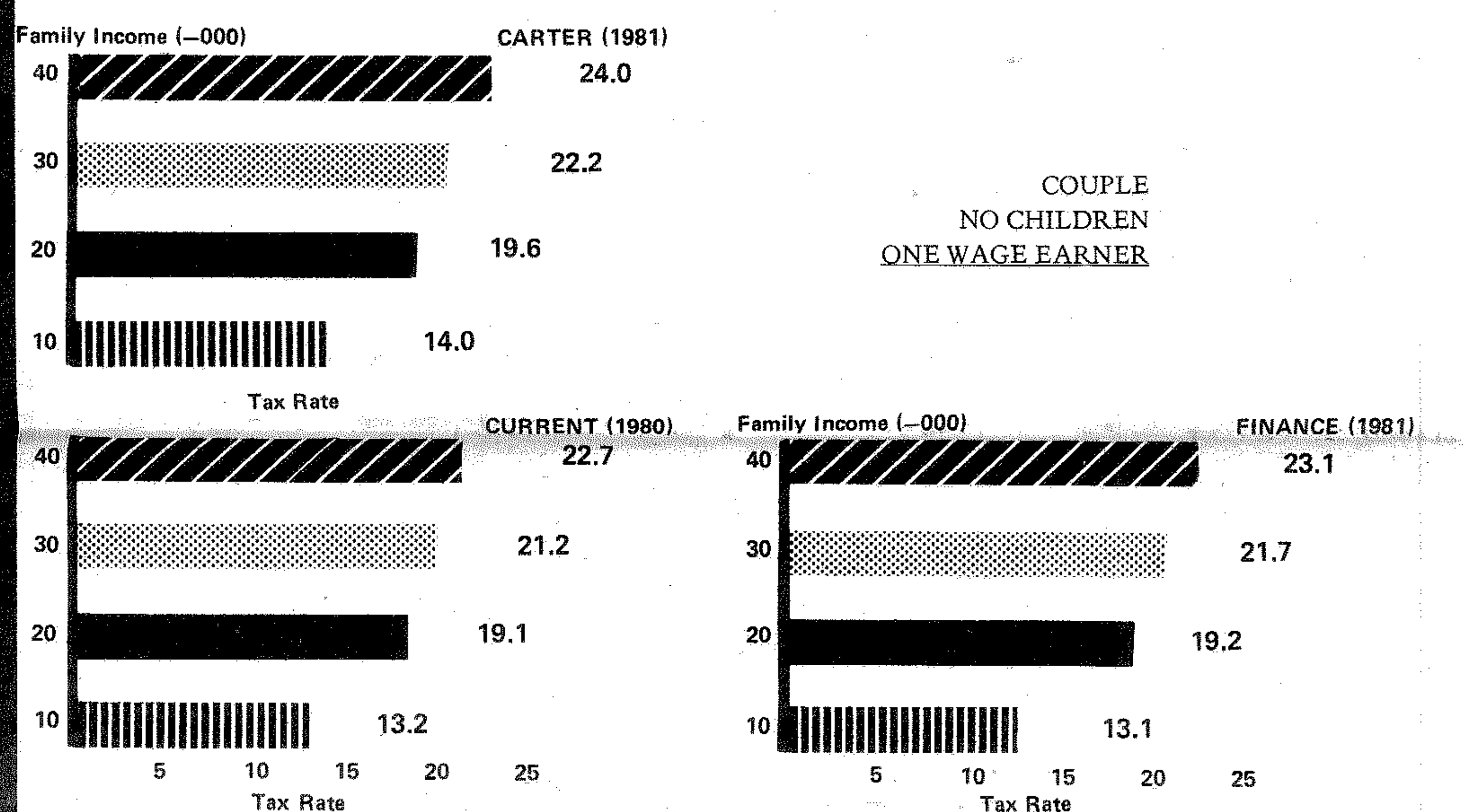
● In 1979, J.C. Penney reported pre-federal tax income of $394 million. Its current U.S. tax bill was $76 million, for an effective rate of 19.3 percent. Under the Price, Waterhouse approach, the tax bill would include $74 million in "deferred taxes" and $7 million in state and local taxes, for an effective rate of 41.4 percent, even before inflation adjustments.

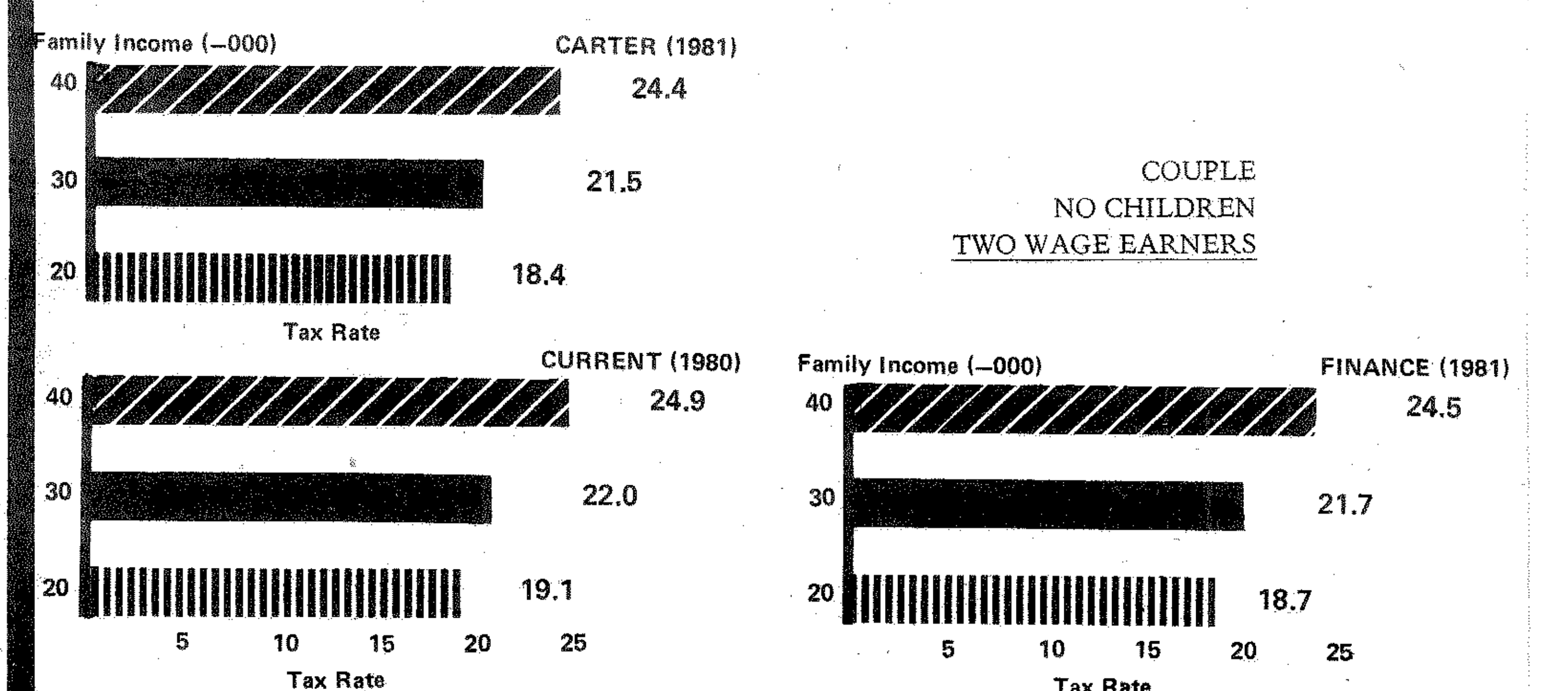
Then, Price, Waterhouse would reduce J.C. Penney's income by $158 million to allow for inflation's effects on inventory and by another $53 million to allow for inflation's effects on depreciation deductions. But it would ignore an offsetting *gain* of $138 million due to inflation adjustments to debt. The Price, Waterhouse result would be to show Penney with "adjusted" pre-tax income of $190 million, and an "effective tax rate" of 87 percent!

In fact, if the debt adjustment is made, the net effect of inflation is to reduce domestic profit by only $73 million, and to increase the effective tax rate by only 4.4 percentage points, from 19.3 percent to 23.7 percent. Furthermore, Penney states in its annual report that it believes that adjusting inventory by general inflation is inappropriate in the retailing industry. Using the adjustment Penney recommends, the net effect of inflation is to *increase* its real profit by $54 million, and to lower its effective current tax rate to only 17 percent. □

Individual Tax "Cuts":





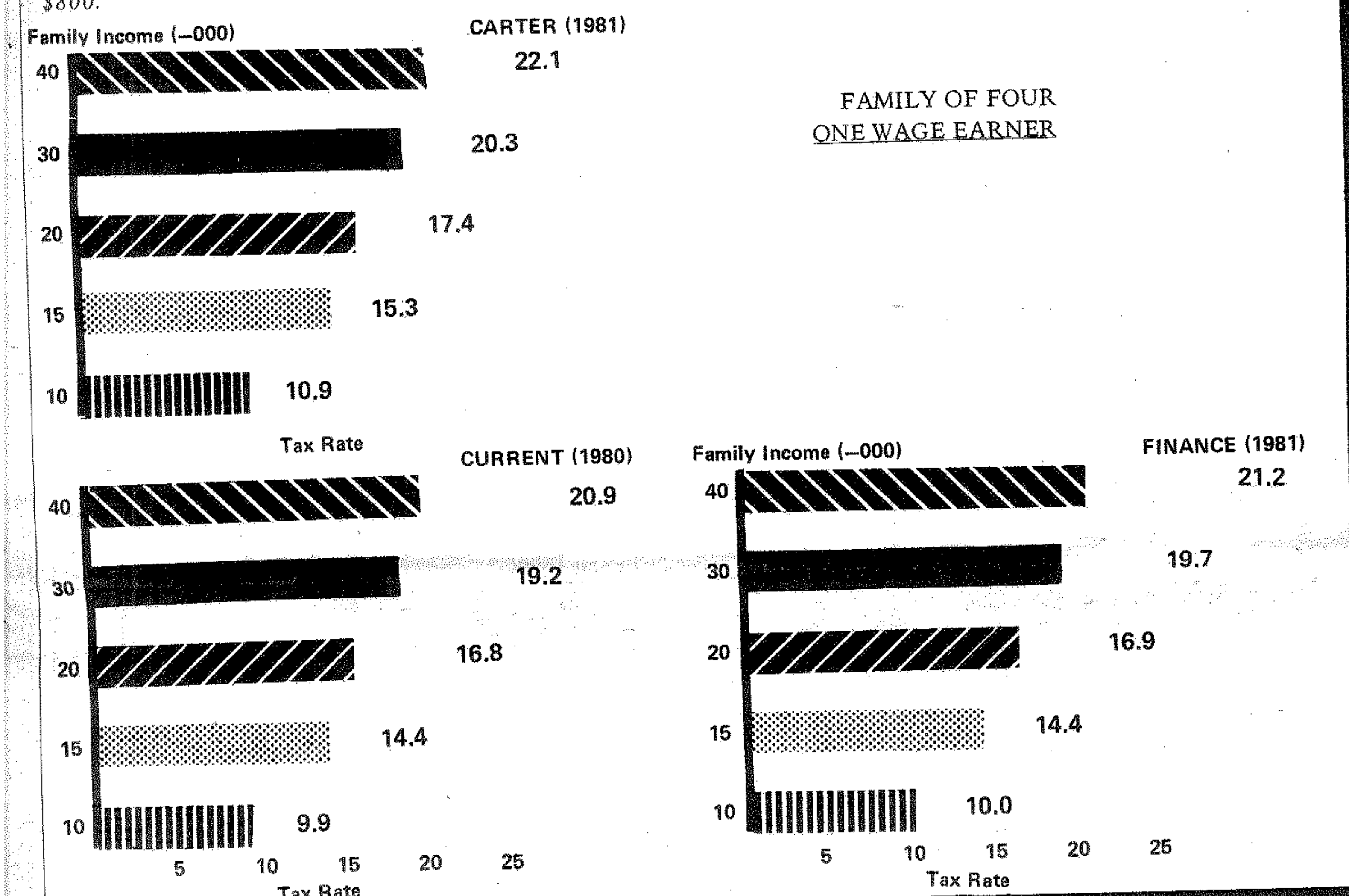


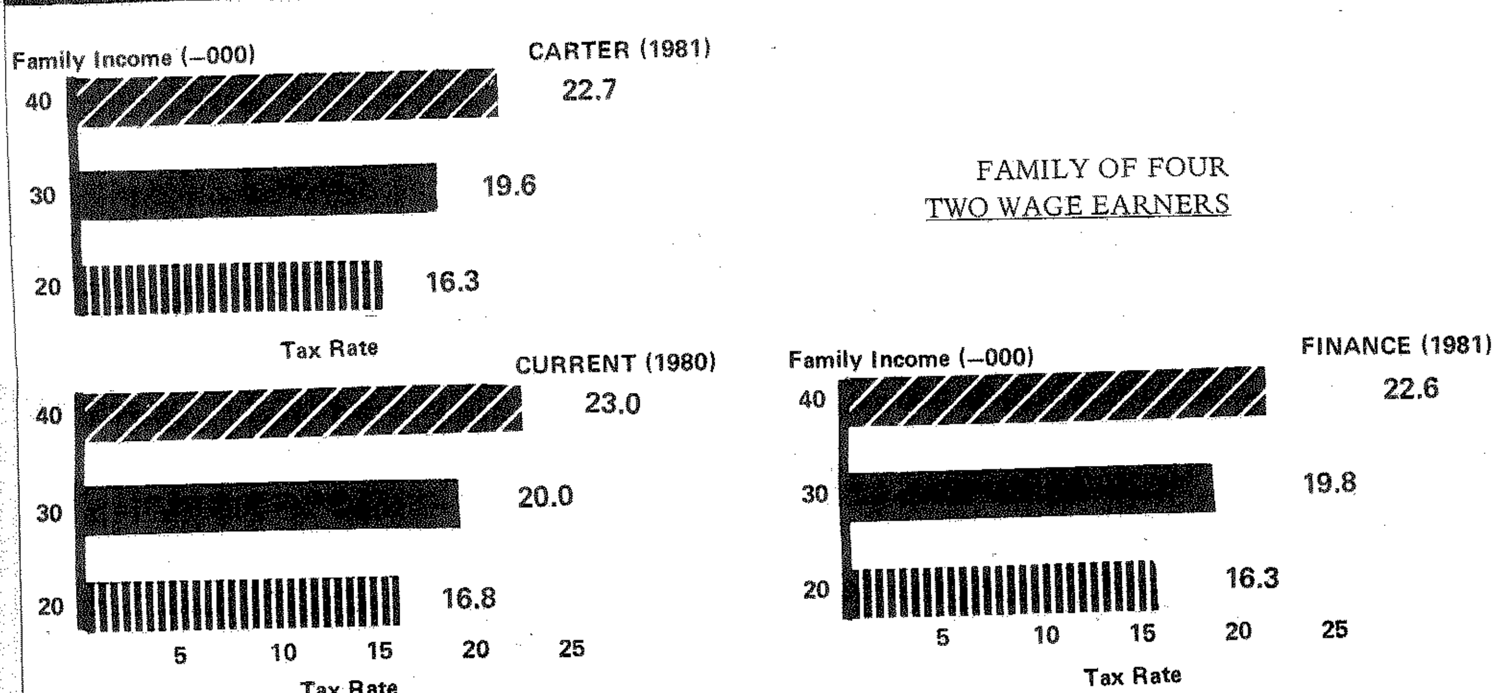
The Different Proposals

CURRENT law figures show total effective tax rates, including both income taxes and social security taxes (employee share only), in 1980 for a variety of incomes and filing statuses. It is assumed that all income is wages potentially subject to social security taxes (6.13 percent up to $25,900 per worker) and that itemized deductions, equal to 20 percent of income, are used when they exceed the zero-bracket amount. For two-earner couples, wage splits are assumed to be 50–50 at $20,000; 60–40 at $30,000; and 62½–37½ at $40,000.

FINANCE and CARTER figures show 1981 tax rates on the same 1980 incomes adjusted for inflation (at nine percent), including social security taxes of 6.65 percent on the first $29,700 in wages per worker. For example, the current tax rate on a one-earner family of four with $20,000 in income is 16.8 percent ($3,365/$20,000). In 1981, under the Carter plan, it would increase to 17.4 percent ($3,801/$21,800), and under the Finance Committee's plan, it would be 16.9 percent ($3,689/$21,800).

Small differences in effective tax rates can be significant in dollar terms. For example, a one percent difference at the $10,000 income level represents $100 in tax liability. A two percent difference at the $40,000 income level represents $800.





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Union Carbide recently issued a report to security analysts explaining why it was *lengthening* its depreciation write-off periods for book purposes by some 35 percent over the tax lives prescribed by the IRS, and sticking with the slow, straight-line depreciation method. The IRS "guideline lives," the report notes, "are not realistic; they are too short. . . . They are not used [for book purposes] by industry generally, nor by any of our competitors." The result of using the IRS lives in the past, Union Carbide states, was to understate its income and to have fully written off many of its assets which are still functioning and producing income. As for 10—5—3 and the claim that it would help measure income more accurately in an inflationary period, Union Carbide concludes: "It would obviously [be] ridiculous to use [such short write-off periods] for book depreciation purposes."

It is also ridiculous for the corporate lobbyists to argue that 10—5—3 makes sense to measure corporate income for tax purposes.

Alternatives

Faster depreciation is not going to reverse our productivity growth decline, and in fact, the distortions and economic waste it would create could actually make things worse. But simply condemning this proposal does not solve the problem, and it is incumbent on the Congress and the administration to explore alternatives which do not entail dismantling of the corporate income tax.

Developing a coherent policy to improve productivity growth requires as clear as possible an understanding of what caused the decline. Although not all the factors have been isolated, those that have been offer some hope, limit what can reasonably be expected, and suggest some strategies for the future.

Some of the factors that contributed to the decline in productivity in the last decade are likely to be less troublesome in the 80s. The huge infusion of relatively unskilled labor into the job market, for example, is not predicted to continue. Other factors, such as the shift in demand toward services and the overriding energy problem, will probably remain. The latter, however, may be somewhat abated by the recent steps taken by Congress and the administration to promote energy conservation. And the shift toward services is not an unmitigated disaster. As Lester Thurow points out, "If we want health care [the fastest growing service area], that is what we want, but one of the inevitable consequences is a lower growth of productivity . . . , even though our sense of well-being may be up."

We are also going to have to continue to live with some declining industries for a period of time. Steel, for example, can never again be as highly in demand as it was when its biggest customer–the auto industry—was building ocean liners on wheels. But as this process occurs, our pre-war steel plants will be retired and steelmaking will be handled at our newer plants (the most modern is the world).

There are two problems that clearly contributed to the decline in productivity growth which a progressive tax policy could address. The first and most important in inflation. As Edward Denison explains in *Accounting for Slower Economic Growth:* "While low productivity growth stimulates inflation, it is also evident that inflation poses a multiple threat to productivity. . . . First, rapid price advances tend to reduce output per unit of input by interfering with efficient operation of domestic and international markets, complicating decisionmaking, and distorting taxation. Second, inflation generally results in governments adopting macroeconomic policies designed to operate the economy below its supply capabilities. The result is . . . underutilization of employed labor and capital that lower their productivity."

Given that traditional approaches to dealing with inflation—all involving contracting the economy and growth—are harmful to productivity increases, Congress ought to explore alternative policies, including tax-based incomes policies, which focus on the cost push side of inflation rather than upon stifling of demand pressures. One approach along these lines is Representative Gephardt's proposal to provide a tax credit for a portion of the social security tax. This regressive tax, which is becoming more and more burdensome on low-, moderate-, and middle-income workers and on small business, is inflationary, leading to higher prices and wages to make up its cost. Furthermore, as it has increased, while subsidies for capital investment have also gone up, business decisions have been artificially tilted away from labor, leading to economic waste. At this time, direct or indirect cuts in the payroll tax appear to have overwhelming economic advantages.

A second factor inhibiting productivity growth involves the economic distortions which federal tax subsidies create in the economy. Rather than continuing to add more "incentives" to the tax code, as the advocates of faster depreciation propose, the Congress should consider jettisoning much of the baggage which the tax system has acquired over the past 60-odd years, and move to a simpler, fairer system with much lower rates. By making taxes a significantly smaller factor in economic decisionmaking, the economy would work better, people would be happier, and in all likelihood, labor and business would be more productive. □

We welcome letters of response from our readers. Letters may have to be edited for length. Unfortunately, we can't handle individual tax problems.

Please address letters to the Editor, *People & Taxes*, 215 Pennsylvania Ave., SE, Washington, DC 20003.

As our readers have no doubt noticed, the summer months have been erratic ones for *People & Taxes*, due to editorial and staff transitions. Since this issue is the second double issue in a row, all subscriptions will be extended for two months. We appreciate your patience.

Why We Need Indexing

by Robert S. McIntyre

According to Bob Woodward and Scott Armstrong in *The Brethern*, the ailing Justice William O. Douglas, attempting to retain his Supreme Court seat in spite of the fact he could no longer read, maintained that he could decide intelligently in the important cases merely by checking the position of Chief Justice Warren Burger and voting the other way. In a similar vein, the recently announced conversion of Senator Lloyd Bentsen (D–Tex.) from a supporter to an opponent of indexing the tax rates for inflation ought to be the occasion for tax reform-oriented liberals to reconsider their traditional opposition to such indexing.

The kind of indexing which deserves liberal attention involves only a simple adjustment of the tax brackets and other fixed dollar figures in the tax code for inflation. In essence, this type of indexing would merely substitute an automatic adjustment for the *ad hoc* tax "cuts" periodically enacted by Congress to offset the "bracket creep" caused by inflation.

Another form of indexing, having to do with the measurement of income from capital investments, is an interesting theoretical concept, but as is discussed below, is virtually impossible to achieve in either a fair or administrable way.

Traditionally, liberals have opposed tax bracket indexing on several grounds:

First, they have feared that without the automatic tax increases caused by inflation, the political lure of tax cuts might lead to reductions in important social programs. With an unindexed system, on the other hand, the politicians can take credit for phony tax cuts and still continue to fund the programs liberals support.

Second, liberals have generally accepted the economists' argument that it is a fiscal virtue for the income tax to go up in real terms during an inflationary period, as an automatic countercyclical tool.

Finally, tax reformers used to argue against indexing on the basis that reforms which shift the distribution of the tax burden are possible only in the context of large general tax cuts. For example, some people feel that the progress in the 70s in taking low income families off the tax rolls might not have been achieved had not inflation necessitated enormous, albeit phony, tax reductions.

If one takes a hard look at the events of the last decade however, it is hard to continue to maintain any of these positions. Certainly, on balance, tax reform goals have not been served by the frequent congressional tax adjustments of the past 10 years. In spite of tax cut bills in 1971, 1975, 1976, 1977, and 1978, individuals came out of the decade bearing a larger share of the overall tax burden than when they went in. The average individual income tax rate stayed about the same, and the personal income tax's contribution to total federal revenues was also about constant. But social security payroll taxes, which primarily fall, directly or indirectly, on individuals, increased substantially. There were real tax cuts in the 70s, but in the aggregate, they went exclusively to corporations. And the gains in cutting taxes for low-income people were matched by huge cuts for the wealthy (like the capital gains tax reduction), meaning an increased burden on the middle class.

As for the fiscal policy argument, the only time inflation was allowed to increase income taxes for any appreciable time was in the 1974–1975 recession, and most analysts admit that it would have been better had taxes been automatically cut at that time. In each other instance, Congress passed tax cut legislation very quickly after inflation had started to push taxes up.

The first argument, that an indexed tax system would endanger social programs, is really the only one which is still made with any vigor. Both liberals and conservatives believe that an indexed system would cut into such programs, a belief which explains not only the liberals' opposition to indexing, but also the conservatives' support.

Lloyd Bentsen

"Indexing would also add a large dose of honesty to the tax legislative process, honesty which many members of Congress may frankly not enjoy, since it would no longer be possible to take credit for huge tax "cuts" which are nothing more than inflation adjustments."

In spite of its wide acceptance, this argument has serious flaws. As noted, there *were* real tax cuts in the 70s, totalling about $40 billion in reduced Treasury revenues annually. But they were all on the corporate side. Had the tax system been indexed, there would still have been substantial room for tax cuts to satisfy the needs of politicians. The difference would have been, in all likelihood, that some or even most of the cuts would have gone to individuals taxpayers.

Our unindexed tax system is a major factor shaping the current Congressional tax cut debate. A supposed key part of the oil decontrol program fashioned by the administration and Congress was a promise to rebate the funds from the windfall profits tax to help average consumers cope with increased energy costs. Instead, however, the Carter administration is now supporting large, *real* corporate tax cuts, and has offered individuals a tax "cut" sop which will not even offset inflation. The Republicans want an even larger corporate cut, and are touting the Kemp-Roth bill for individuals. But at today's inflation rates, Kemp-Roth will cost little more than indexing, and its cuts are heavily tilted toward the very wealthy. Furthermore, the Republicans have made it clear that the corporate cuts are their first priority, and their interest in rebating the windfall profits tax revenues is so low that their platform advocates repeal of the tax.

If the tax rates were indexed, both the Democratic and Republican plans would be exposed as the frauds on average individuals that they are. This fact may be the main reason Senator Bentsen now opposes indexing, and it is a good reason for liberals to change their minds as well.

As mentioned above, there is another kind of indexing—having to do with the measurement of income from investments—which also has some intuitive and theoretical appeal. For example, suppose someone puts $100 in a savings account earning five percent. As the laws now work, at the end of the year, there will be $5 in income from that account subject to tax. But if inflation was 10 percent that year, the saver has actually lost money, since the *real* value of his investment has decreased. It seems a little unfair to rub it in by taxing the $5 in nominal income.

"Capital indexing" would allow for such inflationary losses. For example, if someone buys stock for $100 in 1975 and sells it for $150 in 1980, and the price index has increased by 40 percent over that period, instead of a $50 capital gain ($150–$100), there would only be a $10 capital gain ($150–$140). If someone buys a machine for $100 that will last 10 years, instead of writing off $10 a year for depreciation, the deductions would be indexed, so that the write-off might be $14 in the fifth year. And the person with the five percent savings account would show a tax loss if inflation exceeded five percent.

Sounds great, except that there's a crucial kicker. Inflation also affects debt. If someone *borrows* $100 and inflation is 10 percent, after a year the "real" liability is only $90. So the borrower has made money from inflation. If capital gains, savings accounts, and depreciation write-offs are indexed, then debt has to be indexed as well. Otherwise, nobody with good tax advice would pay any taxes.

Here's a simplified example of what might happen if the tax code indexed investments, but not debt. Suppose your salary is $25,000. To avoid any taxes, you would borrow about $240,000 at, say, 10 percent, and use the money to buy corporate bonds yielding 10 percent. (The bonds could be the security for your loan.) At the end of the year, you cash in the bonds and pay off the loan. Now in reality, you've neither gained nor lost from the transaction; it was a complete wash. But with a partially indexed system, you'd show a tax loss of the inflation rate, say nine percent, times the cost of your bond—a loss big enough to take you right off the tax rolls. There's no question that in a system which indexed investments but not debt it would be easy to purchase such "wash" investments from your friendly tax shelter promoter.

So, indexing investments is not practical unless debt is indexed as well. But since most people are net debtors, such indexing would actually increase their taxes. For example, a homeowner now deducting the interest on his or her nine percent mortgage would more than lose the tax benefits from those deductions if inflation ran at 10 percent.

Furthermore, although the example above may look reasonably straightforward, investment and debt indexing are both extremely complicated. The accountants have not yet agreed on how to deal with debt, and the attempts to draft even capital gains indexing provisions have produced monstrous legislative language and required calculations that would panic most taxpayers.

There is growing dissatisfaction in this country with the high marginal rates of taxation faced by many taxpayers under the personal income tax. Since the income tax is by far the fairest way to raise the revenues needed to fund the government, this discontent should be of great concern to Congress and especially to its liberal members.

One cause of the problem, of course, is the failure of Congress to take steps to simplify and reform the tax system through curtailment of tax loopholes. Unfortunately, the upcoming tax bill is not going to be the vehicle for far-reaching reform measures. But Congress can at least deal with the taxpayer resentment which results from individuals being pushed into higher tax brackets merely because of inflationary boosts in their nominal incomes. The way to do so is by enacting automatic indexing of the tax brackets.

Dean Tipps, executive director of the labor-funded Citizens for Tax Justice, maintains that a significant factor in the defeat of Proposition 9 in California, which would have slashed the state income tax, was the institution of indexing a few years earlier. "People were convinced that the income tax was fair," says Tipps, "and part of the reason was that, unlike the situation with the property tax and Proposition 13, the income tax was not being pushed sky-high by inflation."

Not only would indexing decrease taxpayer resentment it would also help curtail the pattern of the past decade of coupling real tax cuts for business with inflation offsets for individuals. Indexing would also add a large dose of honesty to the tax legislative process, honesty which many members of Congress may frankly not enjoy, since it would no longer be possible to take credit for huge tax "cuts" which are nothing more than inflation adjustments. Indexing would not, of course, obviate the need for future real tax cuts, unless government spending grows at the same rate as real incomes. But it would decrease the frequency such cuts are needed.

Tax bracket indexing is an idea whose time has come. Republicans are committed to this change, even though it is likely to work to the detriment of their corporate constituency. If liberals will support indexing as well, the alliance with Republicans could assure its passage. If the past ten years are any guide, individual taxpayers will be well served if indexing is enacted.

The 'perfect' tax cut?

If one were laying out the criteria for a "perfect" tax cut, the list would probably include the following:

- It should be equitably distributed.
- It should stimulate lagging demand to help us out of the recession and put people back to work, but should not add to the rate of inflation.
- Insofar as it goes to business, it should be as economically neutral as possible and should not favor big companies over small ones.
- It should be easy for taxpayers and the IRS to deal with, not adding any more complexity to the tax laws.

Although it seems almost too good to be true, there is one kind of tax cut which has *all* these advantages: a reduction in social security tax rates. Even more amazing, a proposal with most of these benefits is gaining popularity in Congress, and has a reasonable chance to be included in any tax legislation which is finally approved.

Representative Richard Gephardt (D—Mo.) and Senator Bill Bradley (D—N.J.) are sponsoring a measure to give employers and employees a refundable 10 percent income tax credit for social security taxes paid. The key economic advantage of this approach over a straightforward cut in income tax rates is that employers are likely to perceive their share of the cut as a reduction in wage costs—and therefore cost pressures on prices are likely to be reduced.

The measure does not work as well in this regard as a direct payroll tax cut, but such a direct cut raises serious concerns among some members of Congress, who do not want general revenue financing of social security benefits. This group is also wary of the Gephardt-Bradley credit—especially since Representative Gephardt has made it clear that he would like his bill to be a prelude to some general revenue financing in the future—but the concern is much less.

The 10 percent credit would slightly more than offset the social security tax rate increases scheduled to take effect in January. And just as that rate increase will tend to be regressive, hitting average workers the hardest, the Gephardt-Bradley credit would be quite progressive in application.

The total individual tax cut from the credit would be about $8 billion in 1981. An additional $6 billion would go to business. As noted, in the short run, the business cut is likely to be largely translated into lower prices. In the longer run, it will probably boost wage payments, roughly in the same proportion as the direct cuts.

Because the social security credit is based on wages, its business component would be tilted toward labor-intensive small business, in contrast to most of the business tax cuts of the last 10 years and most of those being proposed now. And the credit would help reduce some of the bias in favor of machines over labor which the current system of capital subsidies fosters.

Unlike a direct cut in payroll taxes, the social security credit does add some administrative costs. Individuals would probably have to fill out an extra line or two on their tax forms, and this is unfortunate. But after a few years, as Representative Gephardt suggests, the credit might be "simplified" into a direct payroll tax reduction.

If the payroll tax credit were coupled with an inflation adjustment in individual tax brackets and exemption, the total cost would be about $29 billion—$23 billion for individuals and $6 billion for businesses. This seems both about the right level and about the right split for a tax cut in 1981. □

"The key economic advantage of this approach over a straightforward cut in income tax rates is that employers are likely to perceive their share of the cut as a reduction in wage costs—and therefore cost pressures on prices are likely to be reduced."

DISTRIBUTION OF TAX REDUCTIONS FROM 10% PAYROLL TAX CREDIT

Expanded income class ($—000)	Percentage of total cut	Percentage cut in total income and payroll taxes	Average reduction per return
Less than $10	14.6%	6.4%	$ 30
$10–15	13.6%	3.8%	75
$15–20	16.1%	3.4%	110
$20–30	30.2%	3.1%	150
$30–50	19.8%	2.3%	200
$50–100	4.6%	1.0%	180
$100 and over	1.0%	0.2%	180
Total (averages)	100.0%	2.7%	$ 85

Legislating Without A Blackboard

As part of its rush to draft tax legislation prior to the election, the Senate Finance Committee held several days of by-invitation-only hearings in late July. The committee heard from a number of leading political economists on the merits and demerits of various individual and corporate tax cutting proposals. Perhaps the most interesting idea on the business side was presented by Professor Dale Jorgensen of Harvard. Professor Jorgensen argued that the major problem with the current tax depreciation rules is that they distort business investment decisions, and that the distortions become intolerable in periods of high inflation. He criticized the 10—5—3 proposal and other accelerated depreciation plans as ineffective and even counterproductive to deal with this situation. Professor Jorgensen suggested a completely different approach to tax depreciation which would completely eliminate the inflation problem and substantially end the distortion problem. Although his proposal has recieved wide circulation in the tax and economic press and had been previously presented to the Finance Committee last October, many members seemed not to understand it. And although the business lobbyists have argued that inflation is one of the major reasons why accelerated depreciation is needed, their representative at the hearings, Charls E. Walker, argued against the Jorgensen plan because it was not generous enough.

The following are excerpts from the testimony at the hearing:

Mr. Jorgensen: I want to begin by going over a few simple relationships between inflation and productivity in the tax code.

First of all, let's recall that the current tax law bases capital recovery [depreciation] on the actual outlays by the taxpayer. But it spaces out the capital recovery over time, just as the capital recovery itself is spaced out over time. So that the actual real value of capital recovery under current law depends on the rate of inflation. . . . [A]t the current rates of inflation of 12 percent, there are substantial differences among the different assets. . . .

Construction machinery, for example, instead of having a 46 percent rate, has a 34 percent rate. . . . That is due largely to the effect of the investment tax credit.

General industrial equipment, that includes things like machine tools, for example, has an effective tax rate of about 36 percent. Trucks, buses, and trailers, which are very short-lived assets and very important in the investment picture, have an effective tax rate that again is still below the 46 percent statutory rate.

On the other hand, . . . industrial and commercial buildings under a 12 percent rate of inflation actually have tax rates that are about the statutory rate. . . .

Now, for six percent inflation rates. You can see that under the current system the effective tax rates for equipment drop down into the teens. In fact, for construction machinery, because again of the generosity of the investment tax credit, the effective tax rate under a six percent rate of inflation is only six percent, whereas for general industrial equipment it is 16 percent, for trucks, buses, and trailers, nine percent, for industrial buildings, 49 and 48, again above the statutory rate of 46 percent.

Well, the conclusion is, then, that inflation has two very substantial impacts under current law. One is that a higher rate of inflation . . . is effectively a legislated tax increase. . . . [I]nflation . . . increases the effective tax rates between a six and a 12 percent rate of inflation by 20 percent in the case of general industrial equipment, by 33 percent in the case of trucks, buses, and trailers, by 28 percent in the case of construction machinery, and by modest amounts for industrial buildings and commercial buildings. . . .

Senator Dole: "I thought we could ask Dr. Walker if in the course of his discussion he could explain to us what Dr. Jorgensen was talking about . . . (I) don't think I understood any of it."

[B]ut the most important conclusion is that whatever the rate of inflation is, . . . the allocation of capital is very greatly distorted by the fact that the actual tax rates that are confronting a business investor are very different for different kinds of assets, and what that means is that the impact of each dollar of capital formation on productivity is reduced, because of the fact that this investment is misdirected. . . .

So, to sum up, there is less investment as a result of the increase in the inflation rate, and at any given rate of inflation, the impact of investment on productivity is blunted as a consequence of the misallocations of investment that takes place. . . .

Some people . . . have felt that the solution to these problems is further acceleration of depreciation and further liberalization of the investment tax credit.

I am here to tell you, gentlemen, that this is like applying a gold-plated bandaid to a gunshot would. It is by far the most expensive form of treatment you could conceive of, and it is totally ineffective in stopping the flow of blood. . . .

[T]he 10- 5—3 proposal . . . is correctly conceived as an effort to reduce tax rates, in other words, to deal with the problem of the incentives to invest.

On the other hand, it is a proposal which has the very serious disadvantage that it blunts further the impact of capital formation on productivity. First of all, . . . [at] 12 percent inflation rates, what is the 10—5—3 proposal going to do?

Well, . . . it provides a lot of help for people who are buying construction machinery and general industrial equipment. It reduces the effective tax rates by about 20 percent in each of those cases. For trucks, buses, and trailers, it is almost a wash, and for industrial buildings there is a lesser reduction of the order of magnitude of perhaps 10 percent. . . .

[B]ut now we come to the key problem here, and that is, what would happen under 10—5- 3 at a six percent rate of inflation? . . .

For trucks, buses, and trailers, for example, the effective rate would be 22 percent at a six percent rate. What would the rate be for construction machinery? Unfortunately, the answer is, a negative 23 percent. In other words, the Conable-Jones proposal, the 10—5—3 proposal, is a proposal for replacing the corporate income tax by a corporate income subsidy.

In other words, the tax rates are negative. Let me just be sure that everybody has understood that point. As we go under the Conable-Jones regime from a 12 percent rate of inflation to a six percent rate, we shift for construction machinery and general industrial equipment from a corporate income tax to a corporate income subsidy. I don't need to tell you, given the people that you are familiar with in the tax business, that negative tax rates- a corporate income subsidy at a six percent rate of inflation—are going to create a tax shelter industry that is going to be big enough to deserve its own line in the GNP accounts. . . .

You can easily visualize what is going to happen. When inflation rates go down to 6 percent, every 70 percent bracket taxpayer in this country is going to get a call from his broker telling him that it is going to be possible for him to eliminate his tax liability altogether by just acquiring and leasing assets that have these negative rates. . .

So, the conclusion is that although 10—5—3 provides additional investment incentives, it is a serious blow to productivity. It will blunt the impact of investment on productivity. So, what is the solution? . . .

What we really need is a treatment for the gunshot wound that is afflicting the American economy as a result of inflation, and what is required is a radical simplification of the capital recovery provisions of the tax code, so that simplification is what I am here to describe as the first year capital recovery system. . . .

[W]hat we would have would be a single number representing the first year allowance. Now, let me indicate how this would work.

This allowance would be a once and for all deduction from current income that would provide for all of capital recovery. That might be, say, 50 cents on the dollar for structures and 75 cents on the dollar for equipment, reflecting the fact that structures are somewhat long-lived assets.

The first year allowances can be set up in such a way that the effective tax rates . . . would be precisely the same on all assets, and the formula is simple algebra. Let me explain it.

The first year recovery allowance is simply the discounted present value of the properly allowable depreciation deductions. To compute this amount you simply multiply the cost of the asset by the ratio of the rate of depreciation to the real rate of return plus the rate of depreciation. . . .

Now let's see how this simple idea solves the problems that are posed by inflation.

First of all, since the deduction, the first year allowance I just mentioned, and the investment on which it is based, are for the same tax year, . . . the value of the deduction to the taxpayer is absolutely independent of the rate of inflation. It is unaffected. We could have an 18 percent rate of inflation. We could have a 12 percent rate of inflation. We could have a six percent rate of inflation. It would leave the effective tax rate absolutely unaffected. . . .

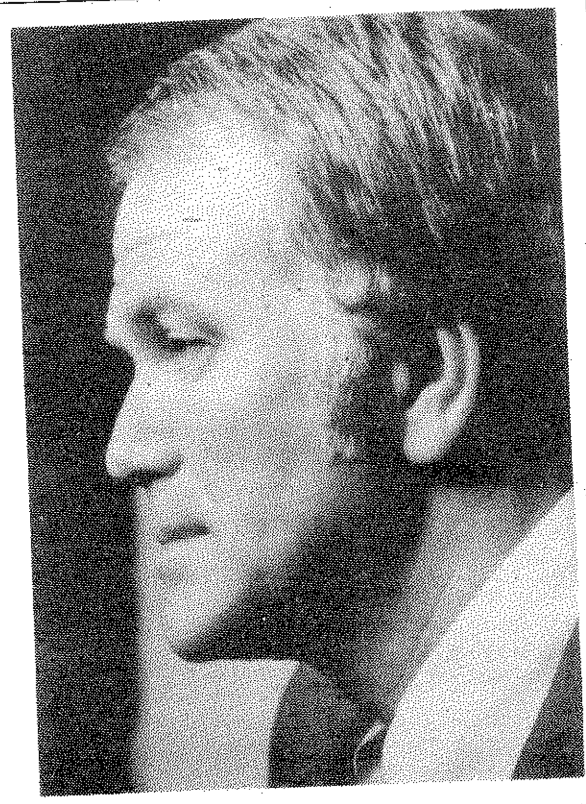
[T]his very simple device is the solution to the problem of completely insulating investment incentives from the impact of inflation. . . .

[T]he first year system that I have described not only insulates the effective tax rate from the impact of inflation, but it assures you that the effective tax rates are going to be the same for all assets.

So, instead of stimulating the growth of a tax shelter industry, the first year system is going to eliminate many opportunities for tax shelter that currently exist. . . .

Senator Packwood: "You kept talking about meeting the competition, about expensing in England, and coming close to expensing in Canada. Isn't it true that what our major competitive Western nations are doing is moving more and more toward regressive taxes, consumption taxes, and lessening their tax on capital investment? Is that what you are suggesting we should move toward?"

Mr. Walker: "We should move toward taxes on consumption . . . Until recently, I favored a value-added tax adjusted for its regressivity."



Naturally, the next question on your minds, is how much is this wonderful conundrum going to cost? Fortunately, there have been a number of estimates of that. . . . [W]e would have a $5.8 billion loss in federal revenue during 1981. . . . In 1982, the loss rises to $13 billion, and the maximum loss, in 1985, is $24.7 billion. By comparison, the corresponding figure for 10—5—3 is —hold your breath— $85 billion. . . .

[T]he out years . . . beyond 1985 show essentially a tailing off of those costs, and by 1990 the impact would be positive, whereas for 10—5—3 it continues, of course, to grow.

So the conclusion is that this is an eminently affordable proposal. It is a proposal which meets the problem of inflation [and] that increases the level of productivity associated with any given level of capital formation. . . .

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Sen. Lloyd Bentsen (D—Tex.), one of the original sponsors of 10—5—3, was familiar with Professor Jorgensen's proposal, and agreed that it had merit. But he was concerned that others might have difficulty comprehending the plan:

Senator Bentsen: Well, I frankly think you would get a better equity in the distribution of the use of the depreciation schedules, but, Dr. Jorgensen, my concern is having people understand it.

Senator Bentsen's fear proved to be a valid one:

The Chairman: Could I ask this question? I came in in the middle of your statement. Do I understand that you are saying you would get your entire write-off insofar as you are going to get the write-off the first year you install the equipment?

Mr. Jorgensen: That is exactly what I mean, Senator. Right. Now, it is very important to distinguish this from expensing. Some people say, why not let them write it off 100 percent. We know why that is not justified, because that would create a system of interest-free loans made by the government to the taxpayer that would be absolutely random in their distribution among different kinds of taxpayers, and would involve billions of dollars.

[M]y system . . . doesn't involve any single element of an interest-free loan from the government to the taxpayer. . . .

The Chairman: I am sorry we don't have a blackboard here, because oftentimes when we in this room talk about some of these things, when we have a blackboard, someone could write an example of your idea up on the blackboard, and we could see what it is. It sounds like a very challenging idea.

Senator Chafee: Mr. Chairman, could I ask one question here?

I must confess, Professor, I have not followed you completely. Unlike the others who have this clear in their minds, I have been a little confused. Could you show me how this works with a $1,000 piece of machine tool equipment? . . . What happens?

Mr. Jorgensen: O.K. You just bought a piece of general industrial equipment. Your depreciation rate is 12 percent.

Senator Chafee: How do you arrive at the 12 percent?

Mr. Jorgensen: The 12 percent is again an empirical matter. It is something which can be determined and has been determined by the Treasury in a study. . . . It is something that you get by actually looking at what prices used equipment is actually selling for. . . . [I]t amounts to picking up your dealer's blue book and finding out what your equipment sold for if it was five years old, six years old, whatever.

Senator Chafee: All right.

Mr. Jorgensen: You end up with 12 percent. All

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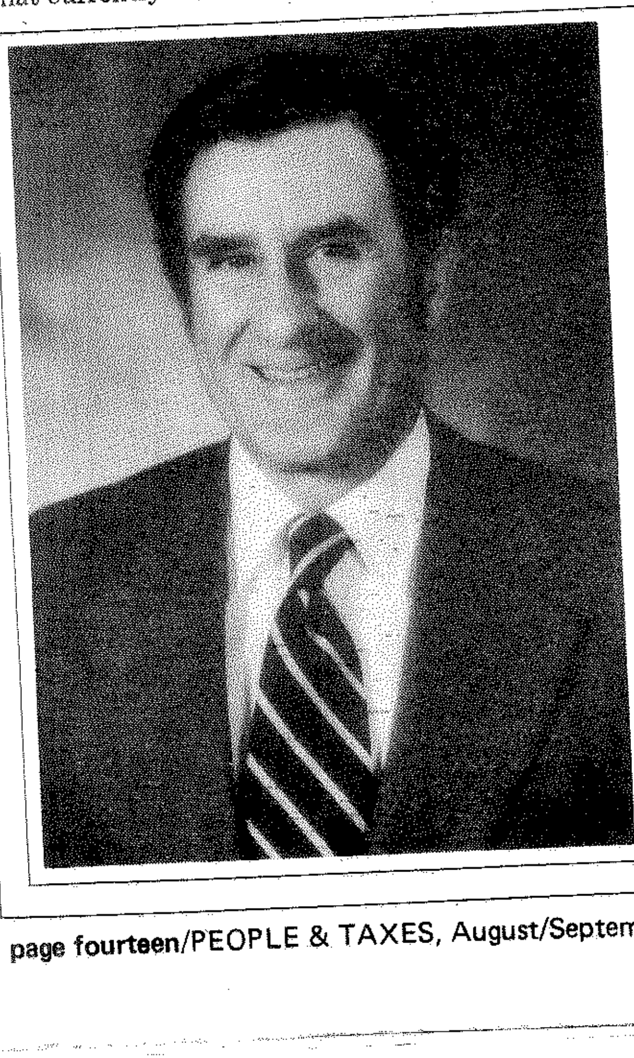

Senator Chafee: "I must confess, Professor, I have not followed you completely. Unlike the others who have this clear in their minds, I have been a little confused. Could you show me how this works . . . ?"

Are Marginal Rates Out of Sight?

FEDERAL INCOME TAX RATES ON THE LAST DOLLAR EARNED:

How Many Taxpayers Pay High Marginal Tax Rates, 1970 and 1977

Marginal Tax Rate	Percentage of Returns		% of Adjusted Gross Income of Those Returns		% of Taxes Paid By Those Returns	
	1970	1977	1970	1977	1970	1977
Under 20%	69.9%	49.1%	42.1%	21.2%	25.3%	6.5%
20%–29%	27.4%	39.1%	42.5%	46.1%	45.2%	40.5%
31%–40%	2.5%	8.7%	7.3%	18.2%	10.7%	23.0%
41%–50%	0.8%	2.3%	3.9%	7.6%	7.4%	12.5%
Over 50%	0.4%	0.9%	4.1%	6.8%	11.4%	17.4%

Are marginal tax rates—the taxes an individual pays on the last dollar he or she earns—getting too high? The answer is probably yes, and the cause is largely the plethora of special tax breaks that make high statutory tax rates necessary to raise the revenues the government needs.

Comparing 1970 to 1977 (the latest year for which IRS statistics are available), the *average* share of an individual's adjusted gross income going for taxes has hardly changed at all—up from 13.3 percent to 13.7 percent.

But the number of taxpayers paying high *marginal* tax rates has increased dramatically—although the percentage of individuals with high marginal rates is still less than many people seem to think.

In 1970, less than 4 percent of individual tax returns showed marginal tax rates over 30 percent. By 1977 this had increased to almost 12 percent of the returns filed. The percentage paying over 50 percent at the margin was up from 0.4 percent to 0.9 percent. The median marginal rate had climbed from 17 percent to 21 percent.

Even in 1977, however, almost half the returns showed rates of less than 20 percent on the last dollar earned, and for another two-fifths of returns, the marginal rates were between 21 percent and 29 percent.

Of course, these figures do not include state income taxes and social security taxes, which can add substantially to marginal rates, especially for average and middle-income workers. □

Connecticut oil-tax overturned

In the last issue, *P & T* reported the passage of Connecticut's two percent "mini-windfall tax" on the sale of all petroleum products within the state by companies that both produce and market those products. The Connecticut tax was expected to be a harbinger for similar state levies across the country.

The tax was designed to recover a share of the tremendous increases in oil company profits now accumulating from high world oil prices. Experts expected that the bulk of the tax would be absorbed by petroleum refiners.

On July 9, however, a federal judge overturned a key provision of the bill. Found unconstitutional was an amendment which prohibited the oil companies from passing the tax-related costs on to consumers. Without the amendment, the law (which took effect on July 1) may well result in a six cents per gallon increase in heating oil prices in addition to price rises in all other petroleum-based products.

The court ruled that the offending provision conflicted with the supremacy clause of the U.S. Constitution. Since the products involved are exempt from price regulation under the federal Emergency Petroleum Allocation Act, the court felt that Connecticut's attempt to control the prices of petroleum products was superseded by the federal law.

The Connecticut legislature, now in recess, could appeal to the Supreme Court or allow the law to stand. Another option would be to repeal the oil profits tax and increase the state sales tax instead. Proponents of the petroleum products tax originally touted the law as a method of increasing state revenues without a sales tax increase. □

THE FEDERAL GOVERNMENT'S SHARE OF GNP

	1949–51	1959–61	1969–71	1979–81
Spending for the general good:				
Defense	5.5%	9.3%	7.8%	4.7%
Non-defense	2.2%	1.8%	2.3%	2.6%
Foreign aid	1.5%	0.4%	0.2%	0.2%
Interest	1.5%	1.3%	1.4%	1.9%
Subtotal	10.7%	12.8%	11.7%	9.4%
Transfers to individuals, corporations and states:				
Transfers to individuals	3.3%	4.3%	5.9%	9.1%
Grants-in-aid to S & L governments	0.8%	1.4%	2.4%	9.1%
Corporate & industry subsidies (net)	0.3%	0.6%	0.6%	0.4%
Subtotal	4.4%	6.3%	8.9%	12.9%
TOTAL	**15.2%**	**19.0%**	**20.6%**	**22.1%**

Is the Fed Too Big?

Conservatives are fond of complaining that the federal government is growing out of control, taking resources out of private hands for governmental uses. They point to the slow but steady increase in federal spending as a percentage of the gross national product (GNP) to support this claim. But in a very real sense, the federal share of the economy has actually been decreasing over the past 30 years.

Currently, over half of what is frequently referred to as federal "spending" involves transfer payments to individuals, grants-in-aid to state and local governments, and subsidies to individuals and businesses. These funds are not consumed by the federal government, but are merely recycled. The single largest item in this category is social security, representing over 20 percent of the current federal budget and almost five percent of GNP. Yet social security benefits are quite clearly spent privately; they are not federal consumption.

When only federal spending for the general good is counted, the trend has been downward as a share of GNP since 1960. The big drop has been in the share of GNP devoted to defense, with far less than offsetting increases in interest payments and the cost of administering non-defense federal programs.

The downward trend in the federal share of the economy is also illustrated by the decline both in the federal share of total civilian employment and in the number of federal workers per 1,000 members of the U.S. population. The former peaked in 1968 at 3.8 percent and is now only 2.8 percent. The latter is at its lowest level in the last 30 years, at 12.3 federal employees per thousand Americans, down from about 16 per thousand in the early fifties and almost 15 per thousand in the late sixties. The state and local workforce, on the other hand, has more than kept pace with the growth in both employment and population, and is now almost five times as large as federal employment, compared to about twice as large in the fifties, and three times as large in the sixties. □

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right, now, let's pursue that. We have a real rate of return of four percent, so we take that depreciation rate of 12 percent and divide by the sum of the depreciation rate and the real rate of return, four percent.

Senator Chafee: Now, the real rate of return, what is that figure? That is the four percent? . . . Is that what we got out of this book? I thought we got depreciation.

Mr. Jorgensen: No. I was just discussing this with Senator Bentsen before you came in. Empirical studies show that the after-tax, after-inflation rate of return in the American economy has averaged four percent over the whole postwar period, so that is our figure. . . .

Now, let's calculate our first year allowance. It is 75 cents on the dollar, because that is the ratio of that 12 percent to the sum of 12 plus four. . . .

Senator Chafee: Now, you lost me again. Don't go too fast. Four percent is your real rate of return.

Mr. Jorgensen: Right.

Senator Chafee: Twelve percent is your depreciation rate.

Mr. Jorgensen: Right.

Senator Chafee: Now, what do you do with those two?

Mr. Jorgensen: You take the ratio of the depreciation rate to the sum of the two, so we take the ratio of 12 percent to the sum, which is 16. That gives us 75 percent.

Senator Chafee: Seventy-five percent . . . .

Mr. Jorgensen: That we apply to our $1,000 investment and our first-year allowance is $750.

Senator Chafee: And that is it?

Mr. Jorgensen: That is it.

Senator Chafee: Thank you.

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The Committee then heard from Charls E. Walker, chairman of the American Council for Capital Formation and the only lobbyist invited to speak at the hearing. Mr. Walker—representing many of the country's largest companies—has often asserted that the need to deal with inflation is a primary argument for 10—5—3. His statement, for example, argued that "because of the rapid rates of inflation, the actual corporate tax is much higher" than it ought to be. But his responses to questions about the Jorgensen plan indicated that dealing with inflation was not his primary concern:

The Chairman: Next we will hear from Dr. Charls Walker, chairman of Charls E. Walker & Associates, and former Deputy Secretary of the Treasury, among many other achievements.

Dr. Walker, we are very happy to have you here today, and we will be pleased to hear your profound views on this subject.

Senator Dole: I thought we could ask Dr. Walker if in the course of his discussion he could explain to us what Dr. Jorgensen was talking about.

Mr. Walker: No. [General laughter.] I can explain to you what I felt was wrong with it.

Senator Dole: I don't think I understood any of it.

Mr. Walker: On Dr. Jorgensen's plan, what didn't come through in his testimony—not that he was trying to hide it, because he is very explicit about it, is that his proposal doesn't do anything to liberalize depreciation, and those of us that have been working for almost two years to develop something like 10—5—3 were trying to develop a more liberal system in order to foster savings, investment, and productivity. . . .

[Dr. Jorgensen] assumes that all of our depreciation problems come from inflation, and that is not true. We've got basically a capital cost recovery system that is too slow, even if you don't have inflation. . . .

I would say that the most critical category of equipment . . . is "general industrial equipment." According to Jorgensen, under the current system, they would pay 46 percent. Is that what we want, a 30-point increase in the tax rate on new and more efficient business equipment? That works exactly in the wrong direction. . . .

Jorgensen says, finally, we all agree that expensing is not justified. I don't think we should argue this in terms of theoretical economics, or how many angels can dance on the head of the pin, or what is the exact life of an asset. I say, let's look around the world and see what is happening. They are expensing in Great Britain now finally, after all these years. They have moved very close to it in Canada. Other countries have very fast depreciation. It is a conscious instrument to try to promote investment in productive equipment, and I couldn't care less if the useful life of something is 40 years. . . .

So, I don't think Dr. Jorgensen's proposal really cuts the mustard. . . .

Senator Chafee: Mr. Walker, I was not here during your presentation, so I may be ploughing over old ground. Did you listen to Professor Jorgensen's proposal?

Mr. Walker: Yes.

Senator Chafee: It seems to me that what his proposal was, after all was said and done, and this may be a simplification of it, but it seems to me that it was permitting the depreciation in the first year of the value of the equipment, less what might be called its recoverable value. Am I shortcutting it too much?

Mr. Walker: Just one word, the discounted value of the equipment.

Senator Chafee: Why that did not have a greater impact on the Treasury I could not figure out, since we took that one piece of machine tool equipment, and applied the formula to it, and depreciated 75 percent of it in the first year, and then nothing else. What did you think of that . . . ?

Mr. Walker: To summarize, the basic problem is that it does not liberalize. . . . The people that worked on 10—5—3 . . . have as their basic goal to liberalize the depreciation system. Not to offset what inflation has done, but to move more closely to what our foreign competition has done. His [Jorgensen's] does not do that. His offsets inflation. . . .

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Finally, Senator Bob Packwood (R—Ore.), the only Finance Committee member to vote against the bill the Committee finally approved, forced Mr. Walker to admit what it is the business community really wants:

Senator Packwood: You kept talking about meeting the competition, about expensing in England, and coming close to expensing in Canada. Isn't it true that what our major corporations are doing is moving more and more toward regressive taxes, consumption taxes, and lessening their tax on capital investment? Is that what you are suggesting we should move toward?

Mr. Walker: We should move toward taxes on consumption. . . . Until recently, I favored a value-added tax adjusted for its regressivity. . . .

Senator Packwood: Let me come back to that. Isn't that basically what our Western European nations have done? They have freed up their capital by skewing their taxes much more heavily on those persons making under $15,000, or marks, whatever the translation is, than we do.

Mr. Walker: Yes, because they rely so heavily on value-added taxes.

Senator Packwood: [T]hey skew it much more toward lower and middle income than we do.

Mr. Walker: Yes. But when you talk about the taxes in Germany being 40 percent of the gross national product . . . .

Senator Packwood: It is 42 percent.

Mr. Walker: You have got two things there. First of all, you can't compare over here with over there, unless you make adjustment for the relative size of the federal, state and local sectors. We are close to 40 percent when we take federal, state and local . . . .

Senator Packwood: No, we are not. Ours are 32 percent counting state and local. . . .

Mr. Walker: That makes some difference, but the real difference is the extent to which they rely on consumption taxes. . . . I would say that the difference in the situation in Germany largely reflects the heavy reliance on the hidden value-added tax. You can have a higher tax burden, and you can stand a higher tax burden . . . .

Senator Packwood: If they don't see it.

Mr Walker: . . . if they don't see it. You get used to it. □